KPMG

Revenue for software and SaaS

Handbook

US GAAP

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Contents

Your guide to software and SaaS revenue recognition

Revenue recognition continues to be top of mind for software and software-as-a-service (SaaS) entities because of the complex nature of their arrangements and evolving business models.

Topic 606 requires software and SaaS entities to make significant judgments and estimates to account for their revenue contracts. In particular, the evolving business practices continue to create new and unique challenges when identifying performance obligations and allocating the transaction price to those performance obligations. Contract modifications also continue to give rise to questions.

This Handbook provides detailed technical guidance on applying Topic 606 (and Subtopic 340-40) to software licensing and SaaS arrangements. We address a wide variety of software and SaaS specific issues and questions that have arisen during and since the adoption of Topic 606. We compare the effects of Topic 606 to those under legacy US GAAP for many longstanding software and SaaS practice issues.

This industry-specific Handbook is a complement to KPMG Handbook, Revenue recognition, which illustrates how Topic 606 applies to common transactions, provides examples about common scenarios, explains our emerging thinking on key interpretative issues and compares the new requirements to legacy US GAAP.

We hope this Handbook will continue to serve as a valuable tool to this industry.

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About this publication

Purpose

The purpose of this Handbook is to assist you in understanding Topic 606 (revenue from contracts with customers) and Subtopic 340-40 (costs from contracts with customers), as they apply to customer arrangements in the software and SaaS industry.

This Handbook focuses on applying Topic 606 and Subtopic 340-40 to software and SaaS arrangements and on those areas with particular relevance thereto. It is intended for use by preparers and other interested parties with a working knowledge of the revenue and contract cost guidance in Topic 606 and Subtopic 340-40.

KPMG Handbook, Revenue recognition, provides additional, non-industry specific guidance on applying Topic 606, Subtopic 340-40 and Subtopic 610-20 (gains and losses from the derecognition of nonfinancial assets).

Organization of the text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we are encountering in practice. We include examples to explain key concepts, and we explain the changes from legacy US GAAP.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples:

— 606-10-25-16 is paragraph 25-16 of ASC Subtopic 606-10.

— ASU 2014-09.BC87 is paragraph 87 of the basis for conclusions to Accounting Standards Update No. 2014-09.

— TRG Agenda Paper No. 30 is agenda paper no. 30 from the meeting of the IASB and the FASB's Joint Transition Resource Group for Revenue Recognition (TRG) held in March 2015.

— SAB Topic 13 is SEC Staff Accounting Bulletin Topic 13.

Terminology

Throughout this Handbook, the terms 'software licensing arrangement' and 'SaaS arrangement' are used. A 'software licensing arrangement' refers to an arrangement in which a software license is transferred to the customer in accordance with paragraph 606-10-55-54(a). In contrast, 'SaaS arrangement' refers to an arrangement that, even if the contract states that a license to software is conveyed, a license does not exist in accordance with paragraph 606-10-55-54(a) because the hosted software does not meet the criteria in paragraph 985-20-15-5.

This distinction is important because, under Topic 606, the licensing implementation guidance, including that related to sales-based and usage-based royalties, does not apply to SaaS arrangements. SaaS arrangements are accounted for as service obligations, subject to the general revenue model. The first section of the 'Software and SaaS Industry Overview' and *Chapter A – Scope*, discuss the requirements for distinguishing between a software licensing arrangement and a SaaS arrangement in further detail.

Accounting literature

Unless otherwise stated, references to the revenue standard and/or Topic 606 comprise all of the following Accounting Standards Updates issued prior to Topic 606's original mandatory adoption date:

- No. 2014-09, Revenue from Contracts with Customers (Topic 606)
- No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)
- No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing
- No. 2016-11, Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting
- No. 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients
- No. 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers
- No. 2017-13, Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments
- No. 2017-14, Income Statement—Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605), and Revenue from Contracts with Customers (Topic 606): Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 116 and SEC Release No. 33-10403

Pending content

In some cases, the Codification is subject to content that becomes effective after the revenue standard. For example, the amendments to the Codification made by Accounting Standards Update No. 2016-02, Leases (Topic 842) and No. 2016-13, Financial Instruments—Credit Losses (Topic 326), are reflected in this Handbook as pending content.

When an excerpt from the Codification is affected by pending content:

- the specific sentences that have been superseded are underlined; and

— the amended sentences are included at the end of the excerpt, marked as pending content.

The transition dates for pending content are shown based on their general applicability to public entities (P) and non-public entities (N). See the relevant Topic to determine the specific transition requirements.

April 2023 edition

This version of the Revenue for software and SaaS Handbook includes new and updated interpretations based on our experiences with companies applying Topic 606, as well as discussions with the FASB and SEC staff.

New Questions and Examples are identified throughout the Handbook with ****** and items that have been significantly updated or revised are identified with **#**.

Software and SaaS industry overview

Is there a software license?

Whether the customer obtains a software license affects the guidance that the entity will apply in accounting for the arrangement.

Instead of selling a software license and related services to the customer, a software entity might make the same software functionality available to the customer through a cloud computing (e.g. software-as-a-service, or SaaS) arrangement.

Under legacy US GAAP, a software license was present in a cloud computing arrangement only if the following criteria were met:

- the customer had the contractual right to take possession of the software from the entity at any time without significant penalty; and
- it was feasible for the customer to host the software independent of the software entity – e.g. to host the software themselves or in a third party's environment.

If not, the entire arrangement was a service arrangement. In our experience, most cloud computing arrangements were accounted for as service contracts under legacy US GAAP.

Topic 606 applies the same tests as legacy US GAAP to determine if a contract with a customer includes a software license. As a result, entities will likely reach similar conclusions for cloud computing arrangements about whether the contract includes a software license.

Under Topic 606, whether the customer obtains a software license affects the guidance that the entity will apply in accounting for the arrangement. If a software license is not granted (i.e. the arrangement is for SaaS), the licensing implementation guidance does not apply, including the specific guidance on sales- or usage-based royalties promised in exchange for a license.

Instead, the entity applies the general revenue model to determine the recognition of revenue for SaaS arrangements. Application of the general revenue model will result in a time-based, ratable recognition of fixed fees in those arrangements. The accounting for variable consideration (e.g. transaction-based fees) is discussed in the section 'Sales- or usage-based royalties'.

Some contracts will include both software licensing elements subject to the licensing implementation guidance and SaaS elements subject to the general revenue model.

Performance obligations

A software entity's determination of the performance obligations in the contract may accelerate software license revenue recognition compared with legacy US GAAP.

Under Topic 606, an entity accounts for the performance obligations in the contract – i.e. the performance obligation is the unit of account for revenue recognition.

To determine the performance obligations in a contract, an entity first identifies the promised goods or services – e.g. a software license, SaaS, professional services, post-contract customer support (PCS), or specified upgrade or additional product rights. These may be promised to the customer explicitly or implicitly (e.g. by the entity's customary business practices), and/or promised to the customer's customers (e.g. a promise to provide technical support or unspecified upgrades to customers that purchase the entity's software from a reseller).

Promised goods or services do not include administrative or other activities that an entity undertakes to set up a contract; for example, certain SaaS installation or activation activities or a promise to provide additional copies of a delivered software application that is not a promise to deliver additional licenses might not transfer a promised good or service to the customer. Judgment will be required in some cases to distinguish promised goods or services from administrative tasks or set-up activities. However, an entity's identification of the promised goods or services in a software or a SaaS arrangement is likely to be similar to that under legacy US GAAP in most cases.

Once an entity identifies the promised goods or services, it then determines whether they are distinct from each other. Under Topic 606, two or more goods or services (e.g. a software license and professional services or PCS, or SaaS and professional services) are distinct from each other, and therefore separate performance obligations, when they are not in effect inputs to a single combined item that is the object of the contract.

In making this determination, an entity considers factors such as whether:

- it is providing a significant integration service (using its expertise to create a combined output using the promised goods or services as inputs);
- one good or service significantly modifies or customizes the other;
- the goods or services are highly dependent on, or highly interrelated with, each other.

Unlike legacy US GAAP for software licensing arrangements, vendor-specific objective evidence of fair value (VSOE) does not factor into an entity's determination of the performance obligations in the contract. In many cases, this difference will accelerate software license revenue recognition compared with legacy US GAAP. For example, a software license is separable from PCS under legacy US GAAP only if the entity has VSOE for the PCS (as well as for any other undelivered elements in the contract). VSOE is established for PCS based on stand-alone sales (e.g. stand-alone PCS renewals).

Software/SaaS and professional services

Consistent with legacy US GAAP, an on-premise software license and significant customization or modification of that software will generally not be distinct from each other; therefore, they will be accounted for as a single performance obligation. Conversely, a software license and non-complex implementation services will generally be distinct from each other and accounted for as separate performance obligations; this is especially, but not exclusively, the case if the services can be performed by alternative providers.

However, judgment may be required in assessing whether a software license and professional services are separate performance obligations in other circumstances. Topic 606 may result in combining a software license and services even when the services are not essential to the software's functionality. For example, some entities may conclude that services are not distinct from the software license when they do not customize or modify the software, but nonetheless are more complex in nature (e.g. complex interfacing), proprietary and integral to the customer's ability to derive substantive benefit from the software.

The considerations for a SaaS arrangement that includes professional services will be similar to those for on-premise software licensing arrangements. SaaS entities will also need to evaluate whether upfront activities are a promised service to the customer or merely set-up activities. Set-up activities, which can range from simply 'activating' the customer to other activities performed by the SaaS provider that enable the customer to access the SaaS from its IT platform, are activities that do not provide incremental benefit to the customer beyond that which the customer receives from access to the hosted application.

Software and PCS

Software licensing arrangements often include PCS. This typically includes technical support and the right to receive unspecified updates, upgrades and enhancements. Legacy US GAAP treated PCS as a single element.

Under Topic 606, the components of PCS (e.g. technical support and the right to unspecified updates, upgrades and enhancements) will typically be distinct from each other, and therefore separate performance obligations. However, if they are provided over the same period and have the same pattern of transfer to the customer – e.g. if they are both stand-ready obligations satisfied ratably over the PCS period – a software entity could account for both elements as if they were a single performance obligation.

In most cases, software, technical support and rights to unspecified updates or upgrades/enhancements (or rights to unspecified additional software products) will be distinct from each other, even if the technical support and the right to unspecified updates, upgrades and enhancements is mandatory. However, Topic 606 illustrates that, in limited fact patterns, a software license may not be distinct from a right to unspecified updates, upgrades and enhancements (or unspecified additional software products) if those updates are critical to the customer's ability to derive benefit and value from the license (e.g. in an anti-virus scenario). In those limited cases, the software and the right to the unspecified items would be a single performance obligation.

Specified upgrades or additional software products

What constitutes a specified upgrade or an additional software product is not expected to change substantively from legacy US GAAP, including the effect of product roadmaps on determining whether a specified upgrade or enhancement has been implicitly promised to the customer.

However, the elimination of the legacy VSOE requirement for undelivered items in a contract means that entities will no longer be required to defer substantially all of the revenue in the contract until any specified upgrades or additional software products are transferred to the customer, as was typical under legacy US GAAP. This is because specified upgrades and specified additional product rights will generally be distinct from the original software license and other elements (e.g. technical support or unspecified upgrade/additional product rights) in a software licensing arrangement.

In SaaS arrangements, judgment will be required to determine whether a promise to provide additional or upgraded functionalities is an additional promised service, or merely part of providing the ongoing SaaS – e.g. keeping the hosted application current and relevant. An important part of that judgment might be whether the promised functionalities are significantly different, significantly improved and/or independent from the original functionalities.

Hybrid SaaS/Cloud arrangements

It is increasingly common for arrangements to include both an on-premise software element and a SaaS element – e.g. an on-premise software application and a SaaS application or a SaaS application with an 'offline' mode. In many cases, those two elements will be distinct, but in others they will not.

If the customer cannot derive benefit from its right to use the on-premise software without the SaaS element, or can only derive an insignificant portion of the benefit the customer would be able to obtain from using the on-premise software together with the SaaS element, the on-premise software license is not distinct from the SaaS element.

In situations where the on-premise software and the SaaS element each have substantive functionality, a key consideration in deciding whether the two elements are distinct may be whether the two elements are transformative to each other rather than merely additive to each other. Transformative means that the two elements together provide a combined functionality or utility that is greater than or different from the aggregate functionality or utility of the elements independently.

Explained another way, if the customer obtains a license to Software Product A and access to SaaS element B, the distinct analysis would generally hinge on whether the combination of A + B equals AB (i.e. the combined functionality is merely the sum of the two elements' individual functionalities), in which case the two elements would generally be distinct from each other, or whether the combination of A + B equals X (i.e. the combination of the two elements results in incremental or changed functionalities that don't exist in either element separately) or AB^x (i.e. the combination of the elements produces an enhanced level of functionality that is greater than the sum of the two elements' individual functionalities).

If the on-premise software and the SaaS element are transformative to each other, rather than merely additive, we would generally conclude that the two elements are not distinct from each other and account for the combined item as a service arrangement, rather than as a license.

Determining stand-alone selling price

VSOE is no longer the only basis for allocating contract revenue. Software entities often agree to provide more than one software license or a combination of software licenses and services to a customer in an arrangement. Multiple-element arrangements may include licenses to additional software products, specified upgrades or enhancements, PCS or other services. Under legacy US GAAP for software licensing arrangements, revenue was allocated between contract elements on the basis of VSOE and, typically, to separate license elements on a residual basis.

Under Topic 606, the transaction price is allocated to the performance obligations based on the stand-alone selling price of the goods or services underlying each performance obligation. If VSOE (or another observable stand-alone selling price) does not exist for a performance obligation, the entity estimates the stand-alone selling price.

For many software entities that have VSOE for their software-related elements (e.g. PCS or professional services), this may not result in a significant change; this is principally because Topic 606 permits use of a residual approach to determine the stand-alone selling price for performance obligations (or bundles of performance obligations) that are sold at widely varying or uncertain prices (e.g. enterprise software licenses) when the other elements of the contract have observable prices. However, the requirement to determine estimated stand-alone selling prices for each performance obligation in the contract will be challenging for many other entities that either:

- do not sell their software-related elements on a stand-alone basis – e.g. customers always purchase PCS that is co-terminus with a term software license; or
- have multiple software licenses – e.g. licenses to multiple software products or a license and one or more specified upgrades – in their contracts that are not transferred to the customer at the same time.

Customer options

A customer option may be an additional performance obligation. However, distinguishing a contractual option from a usage-based fee will require judgment. Software entities may provide a customer option to acquire additional goods or services (including new software licenses or additional licenses of previously delivered software). Under legacy US GAAP, a customer option to purchase additional copies (or seats, users, etc.) of products licensed by and delivered to the customer under the same arrangement was not subject to the guidance for a significant, incremental discount.

In contrast, under Topic 606, a customer option is an additional performance obligation if it provides the customer with a 'material right' that the customer would not have received without entering into the contract – e.g. a discount unavailable to customers that had not entered into a similar contract with the entity.

Distinguishing a contractual option to acquire additional licenses of a previously delivered software product from a usage-based fee will require judgment in many cases. The following should be distinguished:

— an option to acquire additional rights to use the software (e.g. increased capabilities); the acquisition of which constitutes an additional purchasing decision by the customer and requires the entity to grant those additional rights; versus

— a customer's exercise of rights that it already controls (e.g. processing transactions using the licensed software) for which the consideration is variable (i.e. in the form of a usage-based fee).

Timing of revenue

Revenue from licenses

The software license is subject to the new licensing guidance. If a license is not distinct, an entity considers the licensing guidance in applying the general revenue recognition model to the performance obligation that includes the license (e.g. in determining an appropriate measure of progress towards complete satisfaction of the combined performance obligation that includes the license).

Topic 606 divides intellectual property (IP) into two categories.

— **Functional IP.** IP that has significant stand-alone functionality – e.g. the ability to process a transaction, perform a function or task, or be played or aired. Functional IP derives a substantial portion of its utility (i.e. its ability to provide benefit or value) from its significant stand-alone functionality. Topic 606 states that software is functional IP, along with biological compounds or drug formulas, completed media content (e.g. films, television shows or music) and patents underlying highly functional items.

— **Symbolic IP.** IP that does not have significant stand-alone functionality and, therefore, substantially all of the utility of symbolic IP is derived from its association with the licensor's past or ongoing activities. Symbolic IP includes brands, trade names such as a sports team name, logos and franchise rights.

Revenue attributable to a software license that is a separate performance obligation will be recognized at the point in time that the customer obtains control of the license. A customer does not obtain control of a software license before the later of (1) the point in time the customer is provided a copy of the software (or one is made available) and (2) the beginning of the license period.

If a software license is not a separate performance obligation (e.g. the software license is combined with professional services), the entity will apply the general revenue recognition model to determine whether the combined performance obligation should be recognized over time or at a point in time; and, if recognized over time, what the appropriate measure of progress should be.

Electronic delivery

A copy of the software has been provided (or otherwise made available) to the customer when the customer:

— takes possession of the software via download;
— has been provided with the access code (or key) that allows the customer to take immediate possession of the software; or
— has the right to request such access code (or key) at any time and the transfer of such key is effectively administrative or perfunctory.

In a hosting arrangement that includes a software license, control of the license will generally be considered to have been transferred to the customer at the point in time that the hosting services commence.

License renewals

Consistent with revenue attributable to an initial software license, revenue attributable to a software license renewal cannot be recognized before the beginning of the renewal period. This is a change from legacy US GAAP under which revenue attributable to a software license renewal was recognized when the renewal was agreed to by the parties (as long as the other revenue recognition requirements were met).

Revenue from other elements

Rights to unspecified software updates or upgrades/ enhancements

The timing of revenue recognition for unspecified updates, upgrades and enhancements and professional services will be similar to that under legacy US GAAP.

Software entities often provide unspecified updates, upgrades and enhancements to customers on a when-and-if available basis as long as the customers have purchased PCS.

Under legacy US GAAP, the right to unspecified updates, upgrades and enhancements was not considered to be a separate element of the arrangement; instead, it was considered part of PCS. The portion of the fee allocated to PCS was generally recognized ratably over the term of the PCS arrangement.

Under Topic 606, a promise to provide unspecified updates, upgrades and enhancements (or unspecified additional software products) is generally a stand-ready obligation to provide those items on a when-and-if available basis that is satisfied ratably over the PCS period. However, an entity's customary business practice of fulfilling its promise to provide updates, upgrades or enhancements at specific points in time during the PCS period (e.g. regularly providing one updated release each year) might suggest the underlying nature of the entity's promise is not a stand-ready obligation satisfied over time but, rather, a promise to deliver an implied number of updates or upgrades/ enhancements at discrete points in time during the contract period.

Professional services

Software arrangements often include both software and service elements (other than PCS-related services). The services may include training, installation and/or consulting. Consulting services often include implementation support, software design or development or the customization or modification of the licensed software.

Under legacy US GAAP, revenue allocated to a service element that qualified for separate accounting was recognized as services were performed; or, if no pattern of performance was discernible, on a straight-line basis over the period during which the services were performed.

Under Topic 606, entities must meet one of three criteria to recognize revenue over time; if none of those criteria are met, recognition occurs at a point in time. Entities providing professional services in SaaS or software licensing arrangements, either as a separate performance obligation or part of a combined performance obligation, will find in most cases that professional services meet at least one of the over-time recognition criteria.

Sales- or usage-based royalties

Sales- or usage-based fees promised in exchange for a software license will typically not be subject to the general guidance on variable consideration. However, exceptions may arise if the royalty is also promised in exchange for other goods or services. Software entities often enter into arrangements that include sales- or usage-based royalties.

Sales- or usage-based royalties in a software licensing arrangement

Topic 606 contains an exception to the general guidance on variable consideration for sales- or usage-based royalties that are (1) promised solely in exchange for a license of IP or (2) promised in exchange for a license of IP and other goods or services when the license is the predominant item to which the royalty relates. Topic 606 states that the license may be the predominant item "when the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates."

Fees earned from the royalty in either of these cases are recognized at the later of when the subsequent sales or usage occurs, and the satisfaction or partial satisfaction of the performance obligation to which the royalty relates.

In most cases, fees earned from a sales- or usage-based royalty promised in exchange for a software license that is a separate performance obligation will be recognized when the subsequent sales or usage occur. However, exceptions may arise if the royalty is also promised in exchange for other goods or services, regardless of whether the software license is distinct. In addition, any guaranteed royalties (e.g. a fixed minimum amount) are accounted for as fixed consideration and will be recognized in the same manner as any other fixed consideration in the contract.

Royalty reporting on a lag no longer permissible

Under legacy US GAAP, some software entities recognized sales- or usage-based royalties on a 'lag' basis – i.e. they recognized revenue in the period subsequent to that in which the sales or usage occurred because they do not receive reporting about the royalties that the customer owes until the subsequent period.

Under Topic 606, lag reporting is not permitted. If subsequent sales or usage of the entity's software is not known, it must be estimated using the model for estimating variable consideration.

Usage-based fees in a SaaS arrangement

In a SaaS arrangement, the royalties exception does not apply because the arrangement does not contain a software license. Consequently, the general variable consideration guidance in Topic 606 applies rather than the sales- and usage-based royalties exception. Unlike legacy US GAAP, Topic 606 neither limits fees that can be recognized to only those that are fixed or determinable, nor precludes the recognition of contingent revenue.

The new variable consideration guidance may require the SaaS provider to make an estimate of the total usage-based fees (e.g. per transaction fees) that it will earn over the course of the contract, subject to the variable consideration constraint, unless:

— the 'as-invoiced' practical expedient can be applied that permits an entity to recognize revenue in the amount to which it has a right to invoice the customer. This applies if that amount corresponds directly with the value to the customer of the entity's performance completed to date. A significant upfront fee or a usage-based fee rate that changes during the contract period in a manner that cannot be directly linked to a change in value of the entity's services to the customer may preclude use of this expedient; or

— the SaaS performance obligation is determined to be a series of distinct service periods (e.g. a series of distinct daily, monthly or annual periods of service), and allocation of the fees earned to each distinct service period based on the customer's usage each period would reasonably reflect the fees to which the entity expects to be entitled for providing the SaaS for that period. Consistent with the as-invoiced practical expedient, a usage-based fee rate that differs from period to period during the contract may prevent allocation of the fees earned in a single distinct service period to that period, as might a discount or rebate that is based on metrics that cross multiple distinct service periods. However, unlike the as-invoiced practical expedient, an upfront fee generally will not affect whether this condition is met.

Combination of contracts

Whether multiple contracts are combined for software and SaaS entities will be similar to legacy US GAAP in most cases.

Software entities may include multiple promised goods or services in separately executed contracts with the same customer. Under legacy US GAAP, a question arose as to whether the separate contracts should be accounted for individually as distinct arrangements or whether the separate contracts were, in substance, a multiple-element arrangement subject to the revenue allocation provisions.

Under Topic 606, entities are required to combine contracts if (1) the contracts are entered into at or near the same time with the same customer (or related parties) and (2) any one of three criteria is met:

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

Although this is similar to legacy US GAAP, it may result in some different conclusions about whether multiple contracts are combined for software and SaaS entities.

Comparison to current software revenue guidance

Legacy US GAAP software revenue guidance evaluated whether two or more contracts between an entity and a customer should be combined and accounted for as a single arrangement based on six indicators. Some of the indicators were similar to the criteria in Topic 606 – e.g. one of the indicators is that the contracts are negotiated or executed within a short timeframe of each other. However, none of the six indicators is determinative, which could lead to differences in practice under Topic 606.

Comparison to current guidance applied by SaaS providers

Legacy US GAAP general revenue guidance, which was applicable to SaaS providers, contains a rebuttable presumption that contracts entered into at or near the same time should be combined. Because Topic 606 does not contain this presumption and additional criteria must be met, it is possible for entities to come to different conclusions.

Contract costs

Software and SaaS entities will no longer have the choice to expense commissions as incurred if certain criteria are met.

Capitalization of contract costs

Software entities frequently incur either or both:

- costs to obtain a customer contract, including renewal contracts and costs to obtain contract modifications, that are incremental (i.e. would not have been incurred but for obtaining the contract) – e.g. sales commissions and fringe benefits directly attributable to payment of that commission, such as additional 401(k) match or payroll taxes. Costs that are not incremental to obtaining a customer contract are expensed as incurred unless capitalized in accordance with other US GAAP. The following are not incremental costs (not exhaustive):
  - costs that are incurred regardless of whether the contract is obtained – e.g. costs incurred in negotiating or drafting a contract;
  - costs that depend on further substantive performance by the commission recipient, such as continued employment at a future date when all or a portion of the commission will be paid; and
  - payments based on operating metrics like EBITDA or operating income that are not solely linked to obtaining one or more customer contracts.
- costs to fulfill a contract – e.g. costs associated with set-up activities that do not provide a service to the customer in a SaaS arrangement.

Under SEC guidance related to legacy US GAAP, an entity could elect to capitalize direct and incremental contract acquisition costs (e.g. sales commissions) in certain circumstances, although many entities expensed such costs as incurred.

In contrast, under Topic 606, incremental costs to obtain a customer contract and costs to fulfill a contract that meet specified criteria are required to be capitalized as contract cost assets if they are recoverable. Costs to obtain a contract are not required to be capitalized if the expected amortization period, which includes specifically anticipated renewals, is 12 months or less. An entity electing not to capitalize costs to obtain a contract should apply this practical expedient consistently across all of its business units or segments.

The requirement to capitalize contract acquisition and fulfillment costs will be new to most software entities and some SaaS providers and may be complex to apply, especially for entities with many contracts and a variety of contract terms and commission and incentive structures. And for those SaaS providers that currently capitalize contract acquisition costs, they may find the types of costs that can be capitalized will differ because only costs that are incremental to obtaining the contract are capitalizable – allocable costs are not, unless they meet the criteria to be capitalized as fulfillment costs.

Those entities that have not previously tracked the costs of acquiring a contract may find it difficult to determine which costs to capitalize, both for the transition amounts on adoption (regardless of the transition method used) and in the ongoing application of Topic 606.

Amortization and impairment of contract cost assets

Contract cost assets are amortized consistent with the transfer to the customer of the goods or services to which the asset relates, which means that:

— if a contract cost asset relates to two or more goods or services that have a different pattern of transfer to the customer (e.g. one transferred at a point in time and another provided over time), entities should either (1) allocate the contract cost asset to those multiple goods or services on a systematic and rational basis or (2) select a single measure that best reflects the 'use' of the asset as the goods and services are transferred; and/or

— the entity amortizes a contract cost asset over more than the contract period when the asset relates to goods or services that will be provided under an anticipated contract that the entity can identify specifically. For example, an entity will amortize a commission paid for a service contract over the contract period plus any anticipated renewal periods unless the entity also pays commissions for renewals that are commensurate with the commission paid on initial service contracts. 'Commensurate' refers to the commission paid as compared to the margin the entity will earn.

For those SaaS providers that currently capitalize contract acquisition costs, they may find that the amortization period for those costs changes because of the Topic 606 requirement to amortize such costs over specifically anticipated renewal periods (in many cases), which precludes the current practice of amortizing such costs over only the non-cancellable contract period.

Contract cost assets are assessed for impairment in accordance with specific guidance in Topic 606, which assesses the remaining balance of a contract cost asset against the remaining amount of consideration (including variable consideration) that the entity expects to receive from the customer less direct costs to fulfill the related goods or services.

Other considerations

Extended or advanced payments

Software entities often enter into arrangements where payment of a significant portion of the license fee is not due until after expiration of the license, or more than 12 months after delivery of the software.

Under legacy US GAAP, the arrangement fee was presumed not to be fixed or determinable for those arrangements. Unless sufficient evidence existed to overcome this presumption, revenue was generally not recognized until the payments became due and payable.

Under Topic 606, extended payment terms do not preclude revenue recognition so long as collectibility of those payments is considered probable and a contract exists between the parties. Instead, such terms may indicate that there is a risk of a future price concession, which might lead to the conclusion that the transaction price is variable. In that case, the entity will need to consider whether it expects to provide a concession, and the transaction price would be subject to Topic 606's variable consideration guidance, including the variable consideration constraint.

Where extended payment terms are granted, the entity needs to consider whether a significant financing component exists in the contract. Similarly, where a customer prepays in advance for PCS, hosting services or SaaS (and that prepayment relates to a service period greater than one year), the entity will also need to consider whether a significant financing component exists (i.e. whether there is a valid business reason for the advance payment other than the provision of financing and, if not, whether the financing component is 'significant' to the contract). The presence of a significant financing component in either situation would affect the amount of revenue to be recognized by the entity under the contract, with an offsetting amount of interest income (deferred payment terms) or interest expense (advanced payment terms). Whether a significant financing element exists is evaluated at the contract-level; it is not assessed at the performance obligation level or in 'aggregate' for the entity.

Discounted or free services

SaaS providers frequently offer customers free or discounted services in return for entering into longer-term SaaS contracts (e.g. the customer may receive three free or six discounted months of the SaaS service in return for entering into a three-year contract or may receive discounted implementation services).

Under legacy US GAAP, arrangement consideration was limited to only non-contingent amounts (often referred to as the 'contingent cash cap'). That means, in a SaaS contract that provides the customer with three free or six discounted months of service or discounted implementation services, revenue recognized as those free or discounted services are provided was limited to amounts not contingent on the provision of future services.

In contrast, Topic 606 does not have a contingent revenue prohibition. Therefore, SaaS providers will generally allocate additional revenues to free or discounted services provided at the outset of the arrangement compared with legacy US GAAP, which will accelerate overall revenue recognition under contract.

Concessions

Software entities may have a history of granting price or other concessions – e.g. free licenses or services. Under legacy US GAAP, a history of granting price or other concessions meant that the arrangement fees were not fixed or determinable. Revenue under arrangements for these entities may have been significantly deferred, even beyond the point at which cash was received, and was recognized only once the arrangement consideration was deemed to be fixed or determinable.

Under Topic 606, because the fixed or determinable notion does not exist, a history of price or other concessions will generally not result in the complete deferral of revenue. Instead:

— An expectation, based on relevant history or otherwise, of a price concession creates variability in the transaction price for a contract. The existence of variable consideration does not affect the timing of revenue recognition; instead, it affects the amount of revenue that is recognized when (or as) the entity satisfies its performance obligation(s).

— An expectation of providing free goods or services creates additional performance obligations that are accounted for in the same manner as any other performance obligations in the contract. For example, a history of granting free technical support to customers in periods subsequent to the initial support period likely creates an additional performance obligation in the contract for the expected free support periods; therefore, a portion of the transaction price is allocated to this performance obligation and is recognized when (or as) this performance obligation is satisfied.

If an entity grants a concession that was not anticipated at contract inception, that concession will be accounted for as a contract modification.

Sales through distributors or resellers

Many software products are sold to end customers through distributors or resellers. In that case, the entity may grant price concessions through price protection, or accept returns if the distributor is unable to sell the products.

Under legacy US GAAP, some software entities that sell through distributors or resellers concluded that the fees for their software sales were not fixed or determinable because of the risk of granting price concessions or of accepting product returns. Those entities recognized revenue upon sell-through of the software to the end customer.

Under Topic 606, either an expectation of price concessions or returns is accounted for as variable consideration. And because variable consideration does not affect the timing of revenue recognized from the satisfaction of a performance obligation (only the amount), software entities in distributor or reseller arrangements cannot default to a sell-through method under Topic 606.

Rather, an entity is required to determine the total amount of consideration to which it expects to be entitled – e.g. the number of units it expects not to be returned and the amount it expects to be entitled to, after any price concessions, for those units – subject to the variable consideration constraint. The entity recognizes that amount at the time control of the good or service transfers to the distributor or reseller. Certain repurchase rights that exist in some distributor relationships – e.g. the right of the entity to buy back a good until the point in time it is sold to an end customer – will affect when control of the good or service transfers. After control of the good or service transfers, the transaction price is updated each reporting period until the uncertainty for concessions and returns is resolved.

A. Scope

Questions and Examples

Item significantly updated in this edition: #

Scope of Topic 606

Scope of licensing implementation guidance and illustrations

Scope of Topic 606

Excerpt from ASC 606-10

10-4 This guidance specifies the accounting for an individual contract with a customer. However, 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 shall use estimates and assumptions that reflect the size and composition of the portfolio.

15-1 The guidance in this Subtopic applies to all entities.

15-2 An entity shall apply the guidance in this Topic to all **contracts** with **customers**, except the following:

a. Lease contracts within the scope of Topic 840, Leases
b. Contracts within the scope of Topic 944, Financial Services—Insurance.
c. Financial instruments and other contractual rights or obligations within the scope of the following Topics:
    1. Topic 310, Receivables
    2. Topic 320, Investments—Debt Securities
    2a. Topic 321, Investments—Equity Securities
    3. Topic 323, Investments—Equity Method and Joint Ventures
    4. Topic 325, Investments—Other
    5. Topic 405, Liabilities
    6. Topic 470, Debt
    7. Topic 815, Derivatives and Hedging
    8. Topic 825, Financial Instruments
    9. Topic 860, Transfers and Servicing.
d. Guarantees (other than product or service warranties) within the scope of Topic 460, Guarantees.
e. Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Topic 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. Topic 845 on nonmonetary transactions may apply to nonmonetary exchanges that are not within the scope of this Topic.

Pending Content

Transition Date: (P) December 16, 2018; (N) December 16, 2021 ¦ Transition Guidance: 842-10-65-1

a. Lease contracts within the scope of Topic 842, Leases.

15-2A An entity shall consider the guidance in Subtopic 958-605 on not-for-profit entities—revenue recognition—contributions when determining whether a transaction is a contribution within the scope of Subtopic 958-605 or a transaction is within the scope of this Topic.

15-3 An entity shall apply the guidance in this Topic to a contract (other than a contract listed in paragraph 606-10-15-2) only if the counterparty to the contract is a customer. A customer is 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.

20 Glossary

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.

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.

General scoping considerations

Topic 606 replaces substantially all previous US GAAP revenue recognition guidance, including all of the revenue recognition guidance in Topic 605, *Revenue Recognition*, and in Subtopic 985-605, *Software – Revenue Recognition*. However, ASU 2014-09 did *not* supersede the requirements in Subtopic 605-35 or Subtopic 985-605 that pertain to recognizing:

- a provision for losses on long-term construction- and production-type contracts, such as contracts involving the significant production, modification or customization of software; and
- a loss if it becomes probable that the amount of the transaction price allocated to an unsatisfied or partially unsatisfied performance obligation will result in a loss on that performance obligation.

Topic 606 applies broadly to all contracts to deliver goods or services to a 'customer', including contracts to license software to customers (i.e. software licensing arrangements) and contracts to provide customers with 'software-as-a-service' (i.e. SaaS arrangements). However, a contract with a customer is outside the scope of Topic 606 if it comes under the scope of other specific requirements in US GAAP. In some cases, Topic 606 will be applied to part of a contract or, in certain circumstances, to a portfolio of contracts.

A 'customer' is 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.

The definition of a customer focuses on an entity's ordinary activities. However, Topic 606 does not define 'ordinary activities' and, in defining 'revenue', refers to an entity's 'ongoing major or central operations'. The concept of ongoing major or central operations refers to how an entity attempts to fulfill its basic function in the economy of producing and distributing goods or services at prices that enable it to pay for the goods and services it uses and to provide a return to its owners. [ASU 2014-09.BC53, 606-10 Glossary].

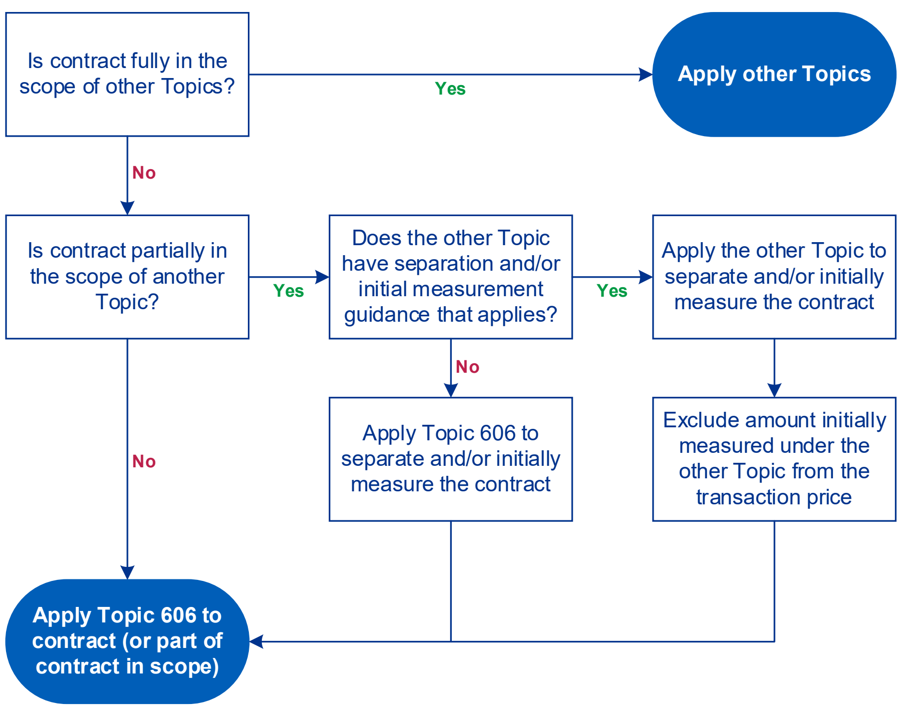
Contracts outside – or partially outside – the scope of Topic 606

Topic 606 excludes from its scope:

- lease contracts;
- contracts within the scope of Topic 944, *Financial Services – Insurance*;
- financial instruments and other contractual rights or obligations in the scope of other specific guidance;
- guarantees (other than product or service warranties); and
- nonmonetary exchanges between entities in the same line of business that facilitate sales to customers other than the parties to the exchange.

A contract with a customer may be partially in the scope of Topic 606 and partially in the scope of other accounting guidance (e.g. a software licensing or SaaS arrangement that includes a lease of related hardware). If the other accounting guidance specifies how to separate or initially measure one or more parts of the contract, then the entity first applies those requirements. Otherwise, the entity applies Topic 606 to separate or initially measure the separately identified parts of the contract. Topic 606, therefore, constitutes 'residual guidance' for separating non-Topic 606 elements from Topic 606 elements within a contract and allocating consideration to those elements. That is, it is applied to the part of the contract that is *not* within the scope of another Topic.

The following flow chart highlights the key considerations when determining the accounting for a contract that is partially in the scope of Topic 606.



Topic 606 excludes from its scope contracts with a collaborator or a partner that is not a customer, but rather shares with the entity the significant risks and benefits of participating in an activity or process. However, a contract with a collaborator or a partner, or part of that contract, is in the scope of Topic 606 if the counterparty meets the definition of a customer for part or all of the arrangement. That is, a contract with a customer may be *part* of an overall collaborative arrangement and Topic 606 is applied to that part.

It will be important for an entity that engages in collaborative arrangements to analyze whether the other parties to these arrangements are customers for some activities. Making this assessment will require judgment and consideration of all applicable facts and circumstances of the arrangement.

Portfolio approach

Topic 606 and Subtopic 340-40 are generally applied to an individual contract with a customer. However, as a practical expedient, an entity may apply the revenue model to a portfolio of contracts (or performance obligations) with similar characteristics *if the entity reasonably expects that the financial statement effects of applying Topic 606 or Subtopic 340-40 to that portfolio would not differ materially from applying it to the individual contracts (or performance obligations) within that portfolio*. Topic 606 and Subtopic 340-40 do not provide specific guidance on how an entity should assess whether the results of a portfolio approach would differ materially from applying the new guidance on a contract-by-contract basis. However, the Basis for Conclusions to ASU 2014-09 (BC69) notes that the Boards did not intend for entities, in order to use the portfolio approach, to have to quantitatively evaluate the accounting outcomes from applying a portfolio approach and not applying a portfolio approach.

In some circumstances when applying Topic 606, an entity will develop estimates using a 'portfolio of data' to account for a specific contract with a customer. For example, entities may use historical data from a population of similar contracts to develop estimates about future sales returns, variable consideration, or expected customer lives. Using a portfolio of data to develop estimates required to apply the guidance in Topic 606 and Subtopic 340-40 is not the same as applying the portfolio approach.

Comparison to legacy US GAAP

Scoping of software licensing arrangements and SaaS arrangements

In general, the guidance in Topic 606 applies to the same population of software and SaaS contracts that is covered by the legacy US GAAP revenue recognition guidance in Topic 605 and Subtopic 985-605.

However, unlike legacy US GAAP, under which software licensing arrangements were subject to the revenue guidance in Subtopic 985-605 (or the guidance in Subtopic 605-35 for arrangements that included the significant production, modification or customization of software) and SaaS arrangements were subject to the general guidance in Topic 605, all software contracts, whether software licensing arrangements or SaaS arrangements, will be subject to the requirements of Topic 606. Consequently, there is no guidance in

Topic 606 on whether software is incidental to a product or service and the legacy guidance that previously distinguished software licensing arrangements from SaaS arrangements does not affect whether Topic 606 applies. However, the legacy US GAAP guidance distinguishing software licensing arrangements from SaaS arrangements (previously included in paragraphs 985-605-55-119 through 55-123, and now included in paragraphs 985-20-15-5 through 15-6) still affects whether the *licensing implementation* guidance in Topic 606 applies to the contract. The licensing guidance in paragraph 606-10-55-54(a) states that a software license is not present in a hosting arrangement that does not meet the criteria in paragraph 985-20-15-5. The questions in this chapter beginning with Question A70 address the application of that guidance.

Accounting for contracts partially in the scope of Topic 606

The guidance on separation and measurement for contracts that are partially in the scope of Topic 606 is consistent with the legacy revenue guidance on multiple-element arrangements.

Collaborative arrangements

The guidance about what constitutes a 'collaborative arrangement' in Topic 808, Collaborative Arrangements, has not changed. Collaborative arrangements continue to be defined as arrangements where:

- the parties are active participants in the arrangement; and
- the participants are exposed to significant risks and rewards that depend on the endeavor's ultimate commercial success.

The guidance in Topic 808 does not address the recognition and measurement of collaborative arrangements, while the guidance on presentation refers entities to other authoritative literature or, if there is no appropriate analogy, suggests that they apply a reasonable, rational and consistently applied accounting policy election. However, Topic 808 was amended by ASU 2014-09 to require that parties to collaborative arrangements specifically consider whether the guidance in Topic 606 is applicable. Topic 808 did not previously require consideration of any specific revenue guidance; however, the implementation guidance in section 808-10-55 (Example 1) now explicitly states that an entity must consider whether the guidance in Topic 606 applies when determining the appropriate accounting for a collaborative arrangement.

Question A10

How does the scoping guidance in Topic 606 apply to arrangements that include parts in the scope of Topic 606 and parts in the scope of the leases guidance?

Interpretive response:

Under Topic 840

Topic 840 provides guidance requiring the separation of lease elements, *including related executory costs*, from non-lease elements outside of its scope. Related executory costs include taxes, maintenance and insurance, but do *not* include 'substantial services' such as operating services or the supply of things like consumables or utilities.

Paragraph 840-10-15-19 does not provide specific guidance on how to allocate arrangement consideration between deliverables in its scope and deliverables outside of its scope. Instead, it refers to the transaction price allocation guidance in paragraphs 606-10-32-28 through 32-41 (i.e. the contract consideration should be allocated on a relative stand-alone selling price basis, subject to the specific guidance on allocating discounts and variable consideration).

Therefore, in the case of a contract that includes the transfer of a software license, or the provision of SaaS, and a lease (see Section 840-10-15 for guidance on identifying a lease), the contract consideration is allocated to the lease elements (which would include the hardware lease *and*, for example, any maintenance services thereon) and the non-lease elements (e.g. a software license and PCS) using the transaction price allocation guidance in Topic 606.

Under Topic 842

Maintenance services provided on leased items are in the scope of Topic 606 and therefore considered a non-lease component of the contract, outside the scope of Topic 842; any component other than the right to use the underlying asset is outside the scope of Topic 842.

Topic 842 provides guidance on separating lease from non-lease components and measuring the consideration in the contract. Paragraph 842-10-15-38 also refers to the transaction price allocation guidance in Topic 606 to allocate consideration to the lease and non-lease components.

Topic 842 (paragraphs 842-10-15-42A – 15-42C) provides lessors with an optional practical expedient to not separate lease from non-lease components of a contract if certain criteria are met. This practical expedient is an accounting policy election made by class of underlying asset if the following criteria are met:

- the timing and pattern of transfer to the lessee of the lease component and the non-lease component(s) associated with that lease component are the same; and
- the lease component, if accounted for separately, would be classified as an operating lease.

If a contract includes multiple non-lease components (one or more that meet these criteria and one or more that do not), the lessor combines those components that meet the criteria with the lease component and separately accounts for each non-lease component that does not.

If the non-lease component(s) is (are) the predominant component(s) of the combined component, the lessor should account for the combined component under Topic 606 instead of the leases guidance in Topic 842. All other combined components would be accounted for under Topic 842 as a single lease component classified as an operating lease. This includes situations in which the lease and non-lease component(s) are equally significant to the contract.

See section 4.4.1 in KPMG Handbook, Leases, for further discussion and analysis, including the disclosure requirements that apply when the practical expedient is elected.

Example A10.1
Partially in scope transaction

ABC Corp. enters into a contract that includes a promise to provide SaaS services to Customer and video equipment for Customer's use. ABC first applies Topic 840 or Topic 842 (if adopted) to assess whether the arrangement contains a lease.

Scenario 1: Topic 842 practical expedient elected

ABC has adopted Topic 842 and determines that:

- use of the video equipment represents an operating lease; and
- the timing and pattern of transfer of the lease is the same as the SaaS services.

It elects to apply the practical expedient, and accounts for the lease and SaaS services combined under Topic 606 because Customer would reasonably be expected to ascribe more value to the SaaS services (non-lease component) than to the right to use the video equipment (lease component) (see paragraph 842-10-15-42B).

Scenario 2: Practical expedient not elected or Topic 842 not yet adopted

ABC elects not to apply the practical expedient in Topic 842 (or ABC has not yet adopted Topic 842), and therefore accounts for the video equipment lease under the applicable leases guidance (Topic 842 or Topic 840).

ABC first applies the applicable leases guidance to identify the lease component and then applies the transaction price allocation guidance in Topic 606 to allocate consideration between the lease and non-lease components. Lastly, ABC accounts for the allocated consideration for the leased video equipment under Topic 840 or Topic 842 (if adopted) and the SaaS services under Topic 606.

Scenario 3: No lease of the video equipment exists

If ABC concludes that the video equipment is not leased, then it accounts for the entire contract under Topic 606. In applying Topic 606, ABC could find that providing the equipment is distinct from providing the services (see Chapter C – Step 2: Identify the performance obligations in the contract).

Question A15
Can an entity have more than one customer for a transaction?

Interpretive response: Yes. A revenue transaction may have multiple counterparties that meet the definition of a customer. Identifying all of an entity's customers is important because, for example, the determination of whether a counterparty is a customer affects the accounting for any consideration payable to that counterparty.

For example, Marketing (agent) markets and incentivizes the purchase of Merchant's (principal) products by providing coupons to Merchant's end customer. Marketing might view both Merchant and Merchant's end customer as its customers. In that case, Marketing evaluates consideration payable to Merchant's end customer to determine whether it is consideration payable to a customer. If it is, then Marketing accounts for that payment as a reduction of revenue rather than as an expense. See *Chapter D – Step 3: Determine the transaction price* for discussion of consideration payable to a customer.

Question A20

What constitutes a 'collaborative arrangement' and what determines whether a collaboration partner is a customer of the software entity?

Excerpt from ASC 808-10

20 Glossary

Collaborative Arrangement

A contractual arrangement that involves a joint operating activity (see paragraph 808-10-15-7). These arrangements involve two (or more) parties that meet both of the following requirements:

a. They are active participants in the activity (see paragraphs 808-10-15-8 through 15-9).
b. They are exposed to significant risks and rewards dependent on the commercial success of the activity (see paragraphs 808-10-15-10 through 15-13).

> Other Considerations

15-5A A collaborative arrangement within the scope of this Topic may be partially within the scope of other topics, including, but not limited to, Topic 606 on revenue from contracts with customers.

15-5B A collaborative arrangement is partially in scope of Topic 606, if a unit of account, identified as a promised good or service (or bundle of goods or services) that is distinct within the collaborative arrangement using the guidance in paragraphs 606-10-15-4 and 606-10-25-19 through 25-22, is with a customer. An entity shall apply the guidance in Topic 606 to a unit of account that is within the scope of that Topic, including the recognition, measurement, presentation, and disclosure requirements. If a portion of a distinct bundle of goods or services is not with a customer, the unit of account is not within the scope of Topic 606.

>> Joint Operating Activity

15-7 The joint operating activities of a collaborative arrangement might involve joint development and commercialization of intellectual property, a drug candidate, software, computer hardware, or a motion picture. For example, a joint operating activity involving a drug candidate may include research and development, marketing (including promotional activities and physician detailing), general and administrative activities, manufacturing, and distribution. However, there may also be collaborative arrangements that do not relate to intellectual property. For example, the activities of a collaborative arrangement may involve joint operation of a facility, such as a hospital. A collaborative arrangement may provide that one participant has sole or primary responsibility for certain activities or that two or more participants have shared responsibility for certain activities. For example, the arrangement may provide for one participant to have primary responsibility for research and development and another participant to have primary responsibility for commercialization of the final product or service.

>> Active Participation

15-8 Whether the parties in a collaborative arrangement are active participants will depend on the facts and circumstances specific to the arrangement. Examples of situations that may evidence active participation of the parties in a collaborative arrangement include, but are not limited to, the following:

a. Directing and carrying out the activities of the joint operating activity
b. Participating on a steering committee or other oversight or governance mechanism
c. Holding a contractual or other legal right to the underlying intellectual property.

15-9 An entity that solely provides financial resources to an endeavor is generally not an active participant in a collaborative arrangement within the scope of this Topic.

>> Significant Risks and Rewards

15-10 Whether the participants in a collaborative arrangement are exposed to significant risks and rewards dependent on the commercial success of the joint operating activity depends on the facts and circumstances specific to the arrangement, including, but not limited to, the terms and conditions of the arrangement.

15-11 The terms and conditions of the arrangement might indicate that participants are not exposed to significant risks and rewards if, for example:

a. Services are performed in exchange for fees paid at market rates.
b. A participant is able to exit the arrangement without cause and recover all (or a significant portion) of its cumulative economic participation to date.
c. Initial profits are allocated to only one participant.
d. There is a limit on the reward that accrues to a participant.

15-12 Other factors that shall be considered in evaluating risks and rewards include:

a. The stage of the endeavor's life cycle
b. The expected duration or extent of the participants' financial participation in the arrangement in relation to the endeavor's total expected life or total expected value.

15-13 Many collaborative arrangements involve licenses of intellectual property, and the participants may exchange consideration related to the license at the inception of the arrangement. Such an exchange does not necessarily indicate that the participants are not exposed to significant risks and rewards dependent on the ultimate commercial success of the endeavor. An entity shall use judgment in determining whether its participation in an arrangement subjects it to significant risks and rewards.

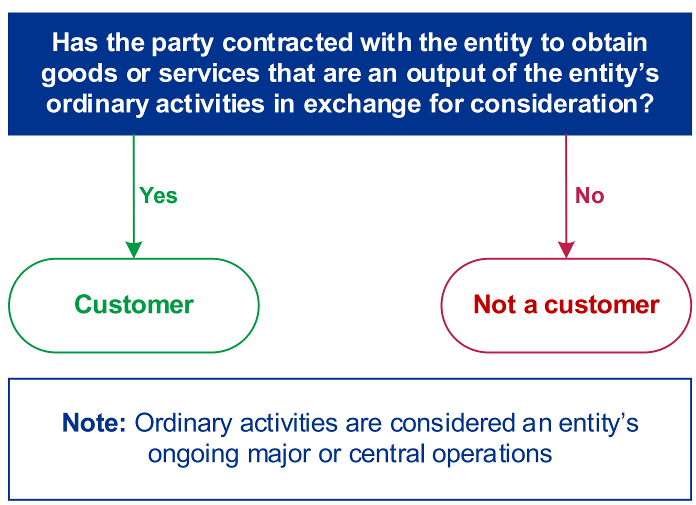
Interpretive response: Software entities frequently enter into arrangements that are described as 'collaborative arrangements'. Topic 606 excludes from its scope contracts with a collaborator or a partner *that is not a customer*, but rather, instead, has contracted with the entity to share in the risks and benefits that result from the collaborative activity or process rather than to obtain an output of the entity's ordinary activities. If an entity's activities in a collaborative arrangement are not within the scope of Topic 606, the entity should apply the guidance in Topic 808. That guidance does not address the recognition and measurement of collaborative arrangements. However, the guidance on presentation refers entities to other authoritative literature or, if there is no appropriate analogy, states that they apply a reasonable, rational and consistently applied accounting policy election.

Therefore, it will be important for a software entity to determine whether:

— an arrangement is a 'collaborative arrangement'; and
— a collaborator or a partner is a 'customer' for any portion of the arrangement.

Even if the arrangement is a 'collaborative arrangement', if the collaborator is a customer for some or all of the contract, the entity's activities related to transferring goods or services that are an output of its ordinary activities are revenue-generating and within the scope of Topic 606.

The guidance in Topic 808 defines a collaborative arrangement, while Topic 606 defines a 'customer'.



Whether an arrangement is a collaboration and whether a party in a collaborative arrangement meets the definition of a customer is judgmental and will depend on the facts and circumstances of the arrangement.

The Basis for Conclusions to ASU 2014-09 (BC54) provides examples of arrangements for which the facts and circumstances will affect whether the arrangements are collaborations, but does not conclude as to whether they are or are not):

— collaborative research and development efforts between biotechnology and pharmaceutical entities or similar arrangements in the aerospace and defense, technology, and healthcare industries, or in higher education;

— arrangements in the oil and gas industry in which partners in an offshore oil and gas field may make payments to each other to settle any differences between their proportionate entitlements to production volumes from the field during a reporting period; and

— arrangements in the not-for-profit industry in which an entity receives grants and sponsorship for research activity and the grantor or sponsor may specify how any output from the research activity will be used.

For those collaboration arrangements or aspects of the arrangement that are in the scope of Topic 808 but are not in the scope of Topic 606, an entity may (but is not required to) analogize to the recognition and measurement guidance in Topic 606 for some or all of the collaboration. If an entity analogizes to Topic 606, it should not present the related revenue together with revenues from contracts with customers that are directly in scope of Topic 606.

Example A20.1

Collaborative arrangement that is within the scope of Topic 606 for one party but not the other party

A software entity and an equipment manufacturer enter into an arrangement to jointly develop software to power a new class of consumer product that the equipment manufacturer will then produce and sell to customers. The entities will both actively participate in the development of the software (e.g. both participate in a joint development committee that is responsible for outlining required specifications for the software and in testing the software in various prototypes of the new consumer product) and will jointly share in the research and development costs of the new software, and, if successful, share in the profits from sales of the new consumer product that uses the software. The software entity will own the IP, and have the right to license it to other customers for applications that do not compete with the equipment manufacturer's product, while the equipment manufacturer will obtain a perpetual license to the IP.

Based on these facts and circumstances, both entities conclude that the arrangement is a 'collaborative arrangement'. However, the two entities reach different conclusions about whether the arrangement is in the scope of Topic 606.

— The software entity's ordinary activities include developing and licensing software; and therefore, the equipment manufacturer, in contracting to obtain a perpetual license to the software entity's software, is contracting to obtain an output of the software entity's ordinary activities. Thus, the equipment manufacturer is a customer and the software development and licensing aspects of this contract are within the scope of Topic 606 for the software entity. Software entities receiving funding in these types of arrangements should analyze the guidance related to funded software development arrangements as discussed in Question A30.

— The equipment manufacturer will participate in the development of software that the software entity will own at the conclusion of the collaboration. The equipment manufacturer does not, as part of its ordinary activities, engage in software development or sell software (or other IP) to other parties. Consequently, the equipment manufacturer concludes that its services, as part of the collaboration, to assist the software entity in developing the software are not within the scope of Topic 606. It should be noted, however, that once the product is developed, the equipment manufacturer's sales of equipment will be within the scope of Topic 606.

Question A30

Are funded software development arrangements within the scope of Topic 606?

Excerpt from ASC 730-20

> Overall Guidance

15-1A This Subtopic also applies to software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software and for which technological feasibility of the computer software product in accordance with the provisions of Subtopic 985-20 on software has not been established before entering into the arrangement. Those arrangements typically provide the funding party with some or all of the following benefits:

a. Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)
b. Discounts on future purchases by the funding party of products produced under the arrangement
c. A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense).

Excerpt from ASC 985-20

> Funded Software-Development Arrangements

25-12 A funded software-development arrangement within the scope of Subtopic 730-20 shall be accounted for in conformity with that Subtopic. If the technological feasibility of the computer software product pursuant to the provisions of this Subtopic has been established before the arrangement has been entered into, Subtopic 730-20 does not apply because the arrangement is not a research and development arrangement. If capitalization of the software-development costs commences pursuant to this Subtopic and the funding party is a collaborator or a partner, any income from the funding party under a funded software-development arrangement shall be credited first to the amount of the development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess shall be deferred and credited against future amounts that subsequently qualify for capitalization. Any deferred amount remaining after the project is completed (that is, when the software is available for general release to customers and capitalization has ceased) shall be credited to income. If the counterparty is a **customer**, the entity shall apply the guidance of Topic 606 on **revenue** from **contracts** with customers.

> Software

60-3 For software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software and for which technological feasibility of the computer software product has not been established before entering into the arrangement, see Subtopic 730-20 on research and development arrangements.

Interpretive response: It depends. The entity would have to consider both: (1) whether the arrangement should be accounted under Subtopic 730-20, *Research and Development—Research and Development Arrangements* (Subtopic 730-20) and (2) whether the funding party meets the definition of a customer. If technological feasibility (see paragraphs 985-20-25-2 and 985-20-55-4 through 55-9) of the related software product has not been established before commencement of a funded software-development arrangement, the guidance in Subtopic 730-20 should be evaluated. Subtopic 730-20 would not apply if technological feasibility is achieved before entering into the arrangement because the arrangement is not a research and development arrangement (see paragraph 985-20-25-12). In addition, Subtopic 730-20 would not apply where the entity does not have the right to retain or acquire the results of the funded software-development arrangement.

Under Subtopic 730-20, all or portions of the funding proceeds are considered to be either: (1) a liability to the funding party or (2) an agreement to provide services. The determination is dependent on whether the entity has an obligation (either implied or stated) to repay the funding regardless of the outcome of the research and development activities. If a funded software development arrangement is determined to be a service arrangement (i.e. the entity's obligation is to perform research and development services, rather than a debt obligation to the funding party), regardless of whether based on the guidance in Subtopic 730-20 (i.e. where the arrangement is not in the scope of Subtopic 730-20 for either reason outlined above), then Topic 606 would apply *if* the funding party meets the definition of a 'customer'.

Topic 606 does not apply to contracts with parties to a contract that are *not* customers such as partners or some collaborators with the entity in developing goods or services (see Question A20). Whether the funding party meets the definition of a customer is judgmental and will likely depend on the facts and circumstances of the funded software development arrangement. Consider the following two scenarios.

Scenario 1

Software Entity X receives funding from a third party (funding party) to develop a software application to map out the locations of oil and natural gas deposits. The third party will obtain a nonexclusive, perpetual license to the software and intends to embed that software as a module into its enterprise resource planning (ERP) software for sale to oil and gas producing entities. In addition to the research funding that it does not have to repay, Software Entity X will also receive future royalties on the third party's sales of its ERP software that includes Software Entity X's module.

Since Entity X is in the business of developing and licensing software to third parties, Entity X concludes in this scenario it is contracting to provide software and services that are an output of its 'ordinary activities'; and therefore, the funding party is a customer. This funded software development arrangement should be accounted for by Software Entity X in accordance with Topic 606, which will include reporting any funding received ahead of the entity's performance in fulfilling its performance obligation(s) in the contract as a contract liability. We believe this would be the appropriate conclusion even if Software Entity X doesn't normally develop mapping software or develop software for oil and gas entities. We believe 'ordinary activities' would apply to the broader consideration that Software Entity X is in business as a software developer that licenses software to third parties.

Scenario 2

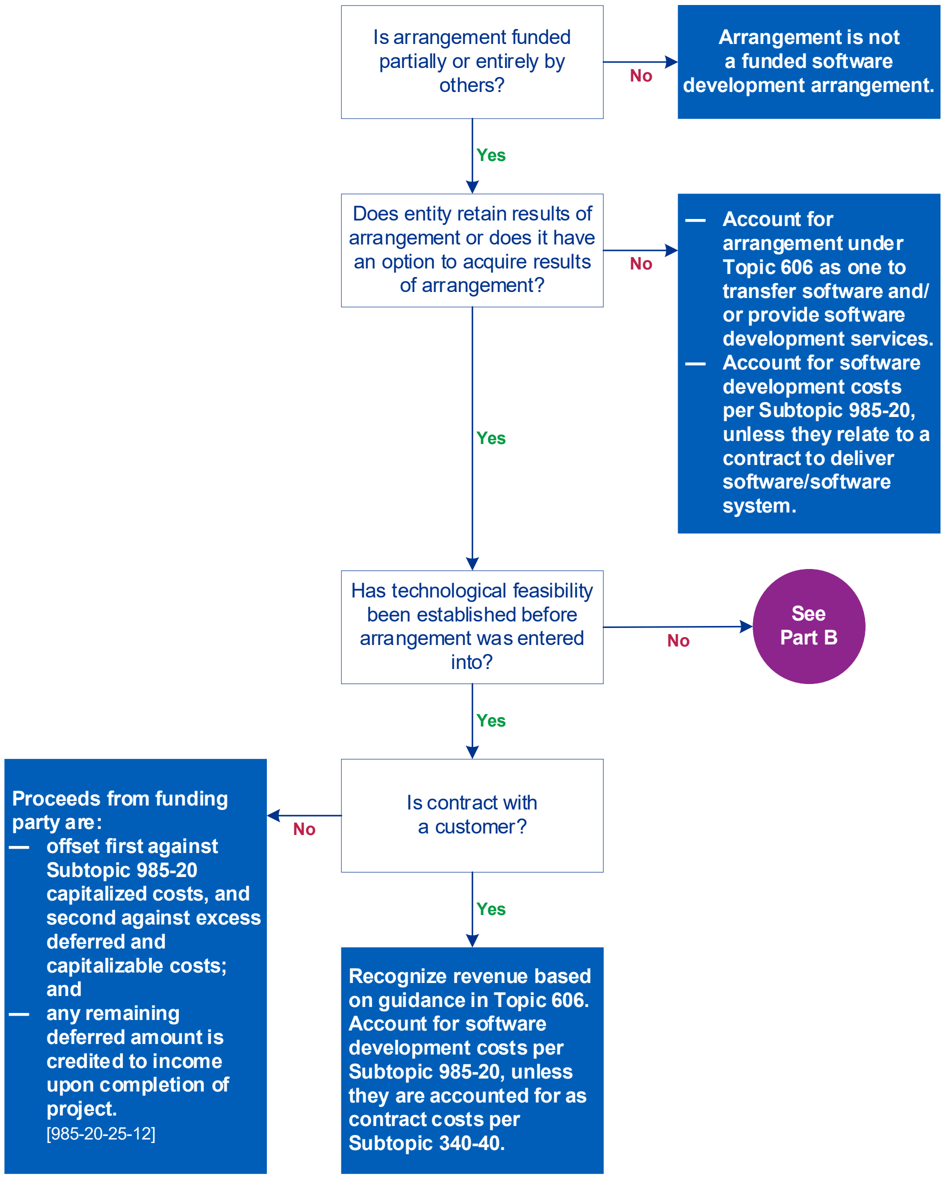
Equipment Entity Y receives funding from a third party to develop a software application to be used in semiconductor research. Equipment Entity Y does not have to repay the funding if it puts forth 'best efforts' in the research and development. Equipment Entity Y will own the developed software, while the funding party will receive a perpetual license to that software. Both parties intend to use the developed software to increase their research efficiency. Equipment Entity Y is not a software developer, nor has it licensed software to customers previously; however, both parties have agreed that, subject to their joint approval, they would license this software to another party if it would not negatively affect their application of the software. In such case, they would split any license fees earned on a 50/50 basis.

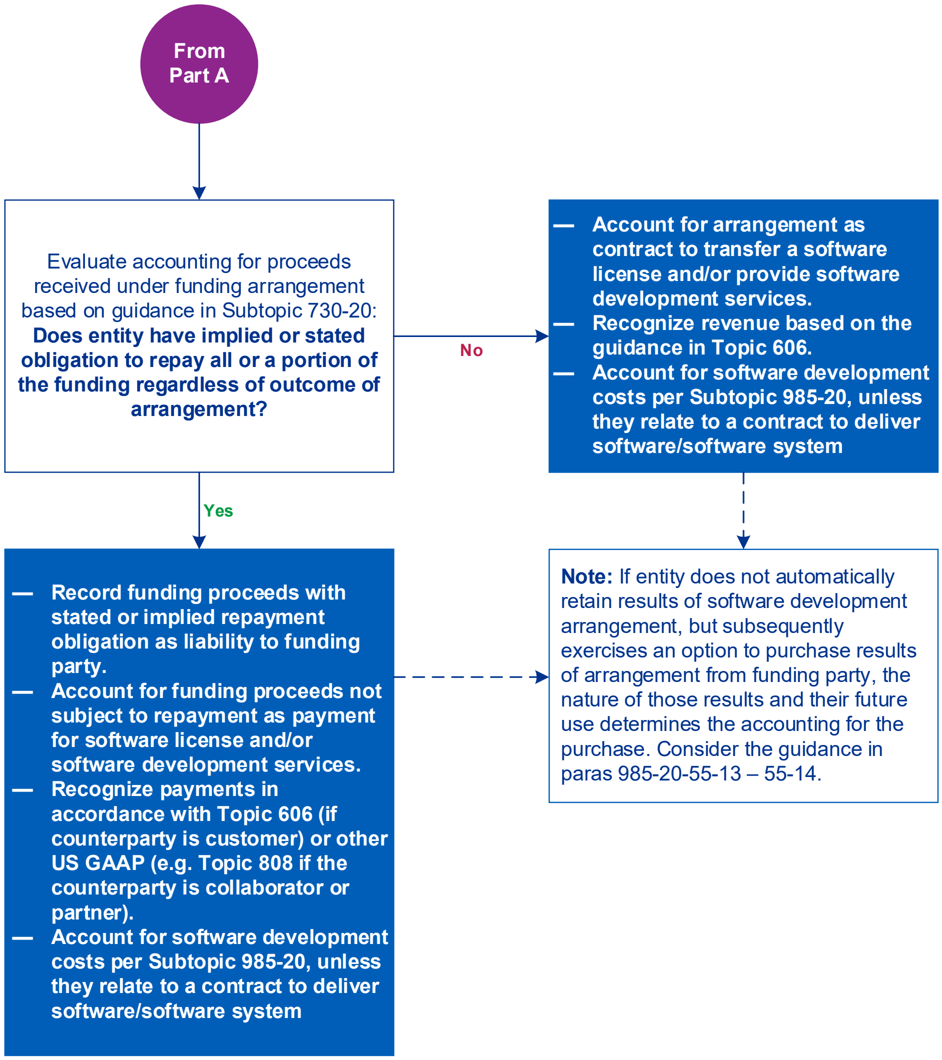
The funding party is determined to be a collaboration partner, rather than a customer, in this fact pattern because Equipment Entity Y's ordinary activities do not include the development and licensing of software. We believe this would be the appropriate conclusion even if Equipment Entity Y had entered into a similar transaction in the past; engaging in an activity on more than one occasion would not in and of itself create a presumption that an activity is 'ordinary' for that entity. We believe a *pattern* of such transactions could call into question whether the funding party is a customer even if Equipment Entity Y's 'primary' activities were semiconductor research and development and licensing the results of those efforts.

As discussed in Question A20, in circumstances where the funding party is determined to be a partner in a 'collaborative arrangement', Topic 808 provides income statement presentation guidance for collaborative arrangements.

However, because Topic 808 does not provide recognition and measurement guidance for collaborative arrangements, the entity will have to apply a reasonable, rational and consistent accounting policy for such arrangements.

Decision tree for analyzing software development arrangements funded or partially funded by others





Is the arrangement funded partially or entirely by others?

If a software entity receives funds from a third party to be used in performing software-development activities, the nature and terms of the arrangement should be analyzed to determine the appropriate accounting for the arrangement. If the arrangement is funded entirely by the software entity, it is not subject to the guidance in this section (i.e. it is not a funded software-developed arrangement).

Does the software entity retain the results of the arrangement or does it have an option to acquire those results?

If the software entity does not retain or have the right to acquire the results of the funded software-development arrangement and the financial risk associated with the arrangement rests solely with the funding parties, the arrangement would be treated as a contract to perform software-development services.

If the software entity retains, or has the right to acquire, the results of the funded software-development arrangement, depending on whether technological feasibility had been established before the arrangement was entered into, either the guidance in Subtopic 730-20 or paragraph 985-20-25-12 would apply to the arrangement. Subtopic 730-20 provides guidance for determining if the entity (1) has an obligation to repay the funding parties or (2) has an income-producing contract to transfer a software license and/or perform research and development services for others.

Example A30.1
Not a funded software development arrangement

ABC Corp., a systems integrator, entered into an arrangement to customize Customer's software based on certain entity-specific functionality requirements. The customized software developed by ABC under this arrangement is the property of Customer, and ABC does not have any rights to obtain the software that is developed as part of this engagement.

ABC does not have the right to acquire the results of the software-development arrangement, and the financial risk associated with the arrangement rests solely with the funding parties, so the arrangement should be accounted for as a contract to perform software-development services (i.e. it is not a funded software-development arrangement).

Example A30.2
Funded software development arrangement (1)

ABC Corp. entered into an arrangement to develop a new networking software application for Customer. The software developed by ABC under this arrangement is the property of ABC and can be marketed to other customers of ABC in the future.

ABC is entitled to the results of the software-development arrangement, so the arrangement should be accounted for as a funded software-development arrangement pursuant to the guidance in Subtopic 730-20 or paragraph 985-20-25-12, depending on whether technological feasibility of the software had been established at inception of the arrangement.

Example A30.3
Funded software development arrangement (2)

ABC Corp. entered into an arrangement to develop a new data mining software application for Customer. The software developed by ABC under this arrangement is the property of ABC and can be marketed to other customers of ABC in the future. Customer will receive a royalty equal to 3% of all future sales of the software product developed by ABC under this arrangement.

ABC is entitled to retain the results of the software-development arrangement in exchange for future royalties to Customer, so the arrangement should be accounted for as a funded software-development arrangement pursuant to the guidance in Subtopic 730-20 or paragraph 985-20-25-12, depending on whether technological feasibility had been established at inception of the arrangement.

Has technological feasibility been established before the arrangement was entered into?

If technological feasibility, as defined in Subtopic 985-20, *Software – Costs of Software to be Sold, Leased, or Marketed*, has been established before the arrangement is entered into, Subtopic 730-20 does not apply because the arrangement is not a research and development arrangement. In that situation, paragraph 985-20-25-12 would apply and the accounting model would be based on whether the contract is with a customer as discussed further below. If the contract is with a customer, Topic 606 would govern the accounting for the arrangement.

If technological feasibility has not been established before a funded software-development arrangement is entered into, Subtopic 730-20 applies to the arrangement.

Is the contract with a customer?

Topic 606 does not apply to contracts with parties to a contract that are not customers, such as partners or collaborators with the entity in developing goods or services to be sold to customers that are not, themselves, customers (see Question A20).

If the contract is not with a customer, paragraph 985-20-25-12 requires that the proceeds from the funding parties first be offset against any costs capitalized for the related software pursuant to Subtopic 985-20. To the extent that the proceeds from the funding parties exceed the software-development costs capitalized, the excess would be deferred and credited against future capitalizable costs. Any remaining deferred amount would be credited to income upon completion of the development activities (i.e. when the software is available for general release to customers).

If the contract is with a customer, paragraph 985-20-25-12 states that the entity should apply the guidance of Topic 606 on revenue from contracts with customers. Software development costs should be accounted for in accordance with Subtopic 985-20, unless such costs are accounted for as contract costs under Topic 606.

Is the software entity obligated to repay all or a portion of the funding?

If a software entity enters into a funded software-development arrangement subject to the provisions of Subtopic 730-20 (i.e. because technological feasibility of the software was not established at inception of the arrangement), that arrangement is accounted for as either (1) a liability to the funding party or (2) an arrangement to transfer software (or a software license) or provide software-development services. If the enterprise may be obligated to repay any amounts to the funding party regardless of the outcome of the software-development arrangement, the software entity should estimate and recognize that liability as a debt obligation. This requirement applies regardless of whether the software entity can settle its obligation by paying cash, issuing securities or by other means (e.g. transferring other assets).

The following are examples of funded software-development arrangements that contain an obligation to repay amounts to the funding party regardless of the outcome of the software development.

— The software entity guarantees repayment of the funds, regardless of the outcome of the software development.

— The funding party can require the software entity to purchase its interest in the software development, regardless of the outcome.

— The funding party is entitled to receive debt or equity securities of the software entity upon completion of the software development, regardless of the outcome.

In some cases, conditions related to the arrangement may indicate that the software entity does not transfer the financial risk of the research and development, even though the funded software-development agreement does not explicitly require repayment of funded amounts. If those conditions suggest that it is probable that the software entity will repay any of the funds regardless of the outcome of the software development, there is a presumption that the enterprise has an obligation to repay the funding party. This presumption can be overcome only by substantial evidence to the contrary. Conditions leading to the presumption that the software entity may be obligated to repay the funding party include the following.

— The software entity has indicated its intent to repay all or a portion of the funding regardless of the outcome of the software-development activities.

— The software entity would incur a severe economic penalty if it did not repay all or a portion of the funding regardless of the outcome of the software-development activities.

— A significant related party relationship exists between the software entity and the funding party.

— The software entity has essentially completed the entire development effort before entering into the arrangement.

As indicated in the preceding paragraph, the existence of a *significant related party relationship* between the enterprise and the parties funding the research and development creates a presumption that the enterprise will repay the funds provided by other parties under a research and development arrangement. Paragraph 730-20-S99-1 clarifies the SEC's view that a *significant related party relationship* exists for purposes of applying the guidance in Subtopic 730-20 when related parties of the entity receiving the funds own 10% or more of the entity providing the funds. Paragraph 730-20-S99-1 also specifies that the presumption that funding will be repaid cannot be overcome by evidence that the entity receiving the funds does not have the resources to repay those amounts based on its current and expected future financial condition. Additionally, the SEC has taken the position that funds received in research and development arrangements from a related party should be accounted for as a liability (i.e. the presumption of repayment cannot be overcome) if:

— the registrant is required to make royalty payments to the related funding party based on its revenues as a whole and not just on the revenues stemming from the products developed with funds provided by the funding party; or

— the registrant has an option, other than a fair value purchase option, to acquire the results of the research and development arrangement.

A software entity that incurs a liability to repay funding parties in connection with a development arrangement should account for the related software-development costs in accordance with Subtopic 985-20 (i.e. in the same manner as software development costs incurred absent the funding arrangement). If the aggregate proceeds to be received under a funded-development arrangement will exceed the liability for the software entity's repayment obligation to the funding party, paragraph 730-20-25-7 requires that the entity recognize its portion of the research and development expense in the same manner as the liability to the funding party is incurred (e.g. as the initial funds are expended or on a pro rata basis). If technological feasibility of the software is established *subsequent* to the inception of the funding arrangement, we believe the guidance in Subtopic 730-20 and Subtopic 985-20 should continue to be applied, rather than the guidance in paragraph 985-20-25-12.

Income recognition under arrangements involving funded software development

If technological feasibility has not been established before a funded software-development arrangement is entered into and the software entity cannot be obligated to repay any amounts to the funding party regardless of the outcome of the research arrangement (i.e. any repayment provisions depend solely on the results of the research and development having a future economic benefit), the entity should account for the arrangement as an obligation to transfer software (or a software license) and/or perform software-development services. As such, the arrangement consideration should be recognized in income based on the provisions of Topic 606 (if the counterparty is a customer) or Topic 610 (if the entity will be transferring a nonfinancial asset – i.e. the software or a license to the software – to a non-customer), in the same manner as arrangements that do not involve the receipt of proceeds from a customer before completion of the related product development.

If technological feasibility has not been established before a funded software-development arrangement is entered into and the aggregate proceeds to be received under the funded-development arrangement will exceed the software entity's liability to the funding party (e.g. the software entity guarantees repayment of only a *portion* of the funding regardless of the outcome of the research and development), the excess proceeds should be accounted for in the same manner as the arrangement consideration in the preceding paragraph.

Income statement presentation for funds credited to income under a funded software-development arrangements

It is necessary to consider all relevant factors when determining the appropriate income statement presentation for funding amounts that are recognized as income. Funding amounts recognized as income should be presented as revenue in the software entity's financial statements if the counterparty is a 'customer'. However, in other situations, funding amounts recognized as income should be presented as other operating income if the entity concludes the arrangement is for the sale of a nonfinancial asset to non-customers or as a reduction of research and development expense (e.g. in certain collaboration scenarios).

Example A30.4
Income-producing arrangement under Subtopic 730-20 (1)

ABC Corp. is developing a new human resources software application (Product X). Before development was complete, ABC entered into a perpetual license agreement with Customer to license software Product X for $1,000,000, due at inception of the arrangement. Product X will be delivered to Customer upon its general release. Additionally, Customer will receive a royalty equal to 3% of all future sales of Product X by ABC. In addition:

- ABC cannot be obligated to repay any amounts to Customer other than the 3% royalty regardless of the outcome of the research arrangement (i.e. the future royalty payments depend solely on the results of the research and development having a future economic benefit).
- ABC retains the results of the development arrangement (Product X) and technological feasibility of Product X has not been established.
- Product X is currently in development and it will be made available for general release concurrently with its delivery to Customer.

Because ABC retains the results of the development arrangement and technological feasibility has not been established, Subtopic 730-20 should be applied. Further, because ABC cannot be obligated to repay any amounts to Customer regardless of the outcome of the research and development, ABC should account for the arrangement as a contract to transfer a license to Product X, when available, in accordance with Topic 606. ABC should account for the software-development costs in accordance with Subtopic 985-20, *Software – Costs of Software to be Sold, Leased, or Marketed* (i.e. in the same manner as software-development costs incurred absent the funding arrangement).

Example A30.5
Income-producing arrangement under Subtopic 730-20 (2)

ABC Corp.'s current product roadmap (development plan) documents ABC's intent to develop additional features and functionality for a future version of its existing data storage software (Product X); however, development of such features has not yet commenced. ABC enters into an arrangement with Customer to license its existing software Product X on a perpetual basis and to perform significant customization services to develop additional features and functionality, including certain of the features included in ABC's current development plan, as well as additional features specifically desired by Customer. The arrangement consideration is $1,000,000, due at inception. ABC retains the intellectual property (or IP) – i.e. the software – resulting from the arrangement with Customer; however, Customer will receive a royalty equal to 3% of all future sales of subsequent versions of Product X that contain features and functionality developed under this arrangement. At inception of the arrangement with Customer, technological feasibility had not been established for either the *customized* software to be delivered under this arrangement or for the next version of Product X. ABC cannot be obligated to repay any amounts to Customer.

ABC believes the development work performed under the arrangement with Customer will expedite development of the next version of Product X containing the features and functionality identified in ABC's current development plan. However, certain of the customized features to be developed under this arrangement are unique to Customer and will not be incorporated in a future version of Product X. ABC believes that the next version of Product X containing certain of the features and functionality to be developed under the arrangement with Customer, as well as additional features identified in ABC's development plan, will be available for general release within six months after completion of the arrangement with Customer. Absent the arrangement with Customer, ABC believes it would have taken several months longer to release the next version of Product X.

ABC (1) retains the IP resulting from the arrangement with Customer, (2) technological feasibility of the *customized* software has not been established before the arrangement was entered into, and (3) the software entity cannot be obligated to repay any amounts to the funding party regardless of the outcome of the research arrangement (i.e. the future royalty payments depend solely on the results of the research and development having a future economic benefit). Therefore, the entity should account for the arrangement as an obligation to transfer a software license and perform software-development services. Although this arrangement encompasses development of features that are in ABC's development plan, it also includes development of features that are not in ABC's development plan, the next version of Product X is not expected to be released until six months after completion of the arrangement with Customer, and the next version of Product X will contain features and functionality that are not being developed in connection with this arrangement.

Because the counterparty in this contract is a customer, the consideration of $1,000,000 paid to ABC by Customer should be recognized as revenue based on the guidance in Topic 606. The software development costs should be accounted for as costs to fulfill the contract with Customer as enumerated in paragraph 985-20-15-3.

Royalties payable to Customer under this arrangement should be recognized as incurred (i.e. when Product X is licensed to third parties).

Example A30.6
Entity can be required to repay funding

ABC Corp. is developing a new human resources software application (Product X). Before development was complete, ABC entered into a perpetual license arrangement with Customer to license software Product X for $1,000,000, due at inception of the arrangement. Product X will be delivered to Customer upon its general release. Additionally, Customer will receive a royalty equal to 3% of future sales of Product X by ABC for a three-year period. Technological feasibility of Product X has not been established as of the inception of the arrangement. If ABC has not paid at least $1,000,000 in royalties to Customer after three years, ABC must pay Customer the difference between $1,000,000 and the actual royalties that were paid during the three-year period.

ABC retains the results of the research and development arrangement (Product X) and technological feasibility has not been established, so Subtopic 730-20 should be applied. ABC can be obligated to repay amounts to Customer up to $1,000,000 regardless of the outcome of the research arrangement (i.e. Customer is guaranteed at least $1,000,000). As such, ABC should account for the funding proceeds as a liability to the funding party. That liability should be reduced in future periods as royalty payments are made. ABC should account for software-development costs in accordance with Subtopic 985-20 (i.e. in the same manner as software-development costs incurred absent the funding arrangement).

Example A30.7

Technological feasibility established before contract inception

ABC Corp. is developing a new inventory-management software application (Product A). Technological feasibility has been established for Product A, and $50,000 of software-development costs have been capitalized pursuant to Subtopic 985-20. On November 15, 20X5, Product A is expected to be made available for general release to customers, at which time capitalization of development costs will cease. On October 15, 20X5, ABC entered into an arrangement with XYZ (who is not a customer) to license Product A for $200,000 due at inception of the contract. As consideration for entering into the license before development is complete, Entity is entitled to a royalty equal to 3% of all future sales of Product A by ABC, up to a maximum of $200,000. ABC cannot be obligated to pay any amounts to Entity other than the 3% royalty.

ABC retains the results of the research and development arrangement (Product A) and technological feasibility has been established, so paragraph 985-20-25-12 should be applied. ABC should apply $50,000 of the arrangement fee to reduce the existing capitalized development costs for Product A to zero and should record the remaining $150,000 of the fee as a deferred credit. That deferred credit should be applied as a reduction of future Product A development costs that qualify for capitalization under Subtopic 985-20. Any remaining credit at completion of Product A development (i.e. upon general release of the software) should be recorded in income at that time. Therefore, if ABC incurred an additional $40,000 of development costs on Product A before general release, $40,000 of the deferred credit would be offset against those capitalizable costs and $110,000 would be credited to income upon general release of Product A. Royalties payable to Customer under this arrangement should be recognized as incurred (i.e. when Product A is licensed to third parties).

Alternatively, if ABC had a similar arrangement with a customer, ABC would account for the arrangement in accordance with the guidance in Topic 606.

Accounting for the acquisition of results of funded software-development arrangements

If the software entity does not automatically retain the results of the arrangement (i.e. the intellectual property developed), but subsequently exercises an option to purchase the results of the software development from the funding party, the nature of those results and their future use should determine the accounting for the purchase transaction. When making that determination, we believe the guidance on accounting for purchased software in paragraphs 985-20-55-13 and 55-14 should be considered.

Comparison to legacy US GAAP

Subtopic 730-20 and the provisions of Subtopic 985-20 with respect to determining whether software was technologically feasible were not changed. As a result, the determination of whether a funded software development arrangement is in the scope of Subtopic 730-20 has not changed, nor has the accounting for such arrangements that represent a liability to a funding party.

Funded software development arrangements that are considered 'income-producing' arrangements (i.e. those to transfer software licenses and/or provide software development services) are accounted for differently subsequent to the adoption of Topic 606 because the standard superseded the legacy US GAAP guidance previously applicable to those arrangements (principally, Subtopics 985-605 and 605-35).

Funded software development arrangements that are collaborations are still subject, as they were under legacy US GAAP, to the provisions in Topic 808. Topic 808 does not provide recognition or measurement guidance for those arrangements; therefore, entities are likely to continue to account for such arrangements in their historical manner.

Question A40

Are nonmonetary exchanges of software within the scope of Topic 606?

Interpretive response: It depends. Many software entities enter into barter transactions to exchange the right to use their software product for rights to use another entity's software product or other nonmonetary goods (e.g. hardware). These transactions vary, but examples include:

— exchanges of a license to the entity's software for a license to another entity's software that will then be sold to customers (either resold on its own or as part of larger arrangement);

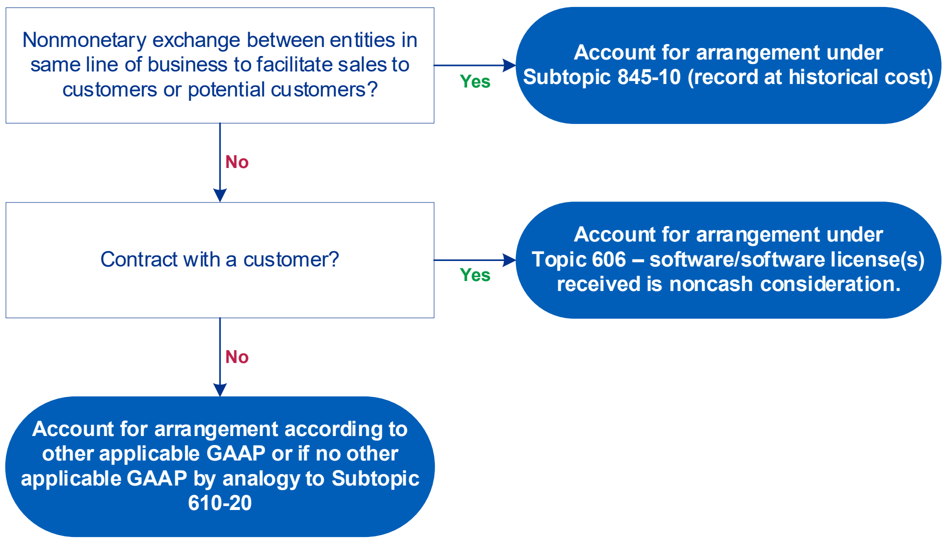
— exchanges of a license to the entity's software to a customer for a license to the customer's software, which the software entity is permitted to sublicense to other customers as a component of the software entity's products;

— exchanges of a license to the entity's software for a license to a customer's software that the software entity plans to use for internal purposes; and

— exchanges of a license to the entity's software that is not an output of its ordinary business activities in exchange for a license to another entity's (i.e. a non-customer's) software/technology that the entity plans to use for internal purposes.

This question does not address situations in which a *customer* exchanges one entity software license for another one. This is discussed in *Chapter C – Step 2: Identify the performance obligations in the contract.*

The following diagram illustrates which guidance is applicable to nonmonetary exchanges of software, and discussion follows the diagram.



Paragraph 606-10-15-2(e) states that nonmonetary exchanges between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange, which would include such exchanges of software, are outside the scope of Topic 606. A software license for software license exchange should be reviewed carefully; the facts and circumstances of each nonmonetary transaction should be considered on a case-by-case basis in determining whether the exchange is of the nature described in paragraph 606-10-15-2(e).

If a software exchange transaction is not between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange, the accounting for that transaction depends on whether the counterparty to the exchange is a customer. This includes exchange transactions for software for internal use. A software exchange with a customer is accounted for as a contract with a customer involving noncash consideration and is within the scope of Topic 606. A software exchange with an entity that is *not* a customer is generally accounted for as the sale of a nonfinancial asset (whether the sale of the software or sale of a license to the software) in exchange for noncash consideration by analogy to Subtopic 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*, which applies the contract identification, transaction price measurement and recognition guidance in Topic 606. For a software exchange to meet the contract identification criteria in Topic 606, it must have commercial substance (see *Chapter B – Step 1: Identify the contract with the customer*). A contract without commercial substance would not meet the criterion in paragraph 606-10-25-1(d), which states that the contract must have '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).

Excerpt from ASC 845-10

> Transactions

15-4 The guidance in the Nonmonetary Transactions Topic does not apply to the following transactions: …

k. The transfer of a nonfinancial asset within the scope of Subtopic 610-20 in exchange for noncash consideration (see paragraphs 610-20-32-2 through 32-3, which require measurement consistent with paragraphs 606-10-32-21 through 32-24).

For software exchanges accounted for in accordance with either Topic 606 or Subtopic 610-20, which applies the same transaction price guidance as Topic 606 (see *Chapter D – Step 3: Determine the transaction price*), the transaction price is measured based on the fair value, at contract inception, of the noncash consideration (i.e. the software or software license) to be received.

If the fair value of the noncash consideration to be received cannot be reasonably estimated by the entity, the entity looks to the stand-alone selling price of the goods or services (i.e. the software or software license) that will be transferred to the other party.

Example A40.1
Nonmonetary exchanges of software

Software Entity XYZ licenses software Product A (a suite of financial accounting applications) to customers in the normal course of business. Product A includes software (Product B) licensed by XYZ from Company PQR (i.e. Product B is PQR's software).

XYZ agrees to exchange a license to Product A with PQR for licenses to Product B. XYZ intends to re-license Product B (as a stand-alone product or embedded in Product A) to its customers. PQR intends to use Product A for internal use. The fair value of a license to Product A is reasonably estimable.

XYZ is a customer of PQR (XYZ's Product A includes PQR's Product B that is an output of PQR's ordinary activities) and vice versa (PQR is licensing XYZ's Product A that is an output of its ordinary activities).

However, from XYZ's perspective, the transaction is not in the scope of Topic 606 because the arrangement is a nonmonetary exchange between entities in the same line of business to facilitate sales to XYZ's customers (Product B is used in Product A).

From PQR's perspective, the arrangement is within the scope of Topic 606 because PQR is receiving a license to Product A in exchange for licenses to Product B that are an output of PQR's ordinary activities (i.e. the arrangement is a contract with a customer).

Accounting by Software Entity XYZ

The exchange of a license to Product A for a license to Product B is an exchange of a product held for sale in the ordinary course of business for a product to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange. The exchange is, therefore, recorded at carryover basis (which might be $0) under the guidance of Subtopic 845-10 – i.e. no revenue is recognized until Product B is sublicensed to other customers in a subsequent transaction (through XYZ licensing Product A that includes a sublicense to Product B).

Accounting by Company PQR

As outlined above, the exchange of licenses to Product B for a license to Product A by Company PQR is a transaction with a customer within the scope of Topic 606. The exchange is, therefore, accounted for by Company PQR under the Topic 606 guidance for noncash consideration. Therefore, PQR measures the noncash consideration – the license to Product A – at fair value and revenue is recognized by PQR when it transfers control of the license to Product B to XYZ.

Comparison to legacy US GAAP

Software or software licenses received by the software entity sold, licensed or leased in the same line of business as the software entity's software or software licenses

Nonmonetary exchanges of software were specifically addressed in Subtopic 985-845, *Software – Non-monetary Transactions*. Subtopic 985-845 specified that the software entity should record an exchange at carryover basis when the technology/products received by the software entity in the exchange would be sold, licensed or leased in the same line of business as the software entity's products that were delivered in the exchange. The amendments to US GAAP resulting from ASU 2014-09 will generally not change the accounting for exchanges of software between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange. In general, such exchanges will continue to be recorded at carryover basis in accordance with Subtopic 845-10.

Other software exchanges

However, if the software or software license received by the software entity in the exchange would not be sold, licensed or leased in the same line of business as the software entity's software or licenses that were delivered in the exchange, the software entity would record the exchange at fair value, provided that:

- the fair value of the software/software licenses exchanged or received could be determined within reasonable limits (for an exchange transaction involving software, entity-specific evidence of fair value (VSOE) for the deliverables given up or received was required to meet this criterion); and
- the software/software licenses received in the exchange were expected, at the time of the exchange, to be used by the software entity and the value ascribed to the transaction reasonably reflected the expected use.

If either condition was not met, the exchange was recorded at carryover basis. Under legacy US GAAP, the fair value of the software received or transferred was established only through VSOE, which was typically not available. Consequently, most software exchanges under legacy US GAAP were recorded at carryover basis, rather than at fair value.

For nonmonetary exchanges not within the scope of Subtopic 845-10 (e.g. the entity transfers a license to its software that is an output of its ordinary activities in exchange for a license to the counterparty's software that the entity will use for internal purposes), the application of Topic 606 or Subtopic 610-20 to the exchange may result in substantially different accounting from legacy US GAAP. Software exchanges within the scope of Topic 606 or accounted for by analogy to Subtopic 610-20 will never be recorded at carryover basis; they will be recorded based on the fair value of the software (or software licenses) the entity receives in the exchange if that is reasonably estimable and, if not, based on the stand-alone selling price of the software (or software licenses) that will be transferred to the counterparty.

VSOE does not apply either to the determination of the fair value of the software (or licenses) received nor to the stand-alone selling price of the software (or licenses) to be transferred.

Question A50

What is the accounting for an exchange of software licenses between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange?

Interpretive response: Nonmonetary exchanges of software between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange will follow the general nonmonetary exchanges guidance in Subtopic 845-10. In accordance with Subtopic 845-10, a software entity should record an exchange at carryover basis when the software licenses received by the software entity in the exchange will be sold, licensed or leased in the same line of business as the software entity's software licenses that were delivered in the exchange (i.e. no revenue should be recognized until the counterparty's software is sublicensed to other customers in a subsequent transaction).

Question A60#

Can an entity record proceeds received from the settlement of a patent infringement with another party as revenue?

Interpretive response: We believe it depends on whether the proceeds constitute revenue. Revenue is defined in Topic 606 and the ASC Master Glossary as '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'.

This approach to the evaluation is consistent with that taken under pre-Topic 606 legacy US GAAP, which, in the absence of a codified definition of revenue, looked to the Conceptual Framework (CON 6) for determining classification of the settlement amount. The Topic 606 and ASC Master Glossary definition of 'revenue' is unchanged from the legacy definition of revenue in CON 6. Therefore, we believe in these scenarios that Topic 606 did **not** change: [606-10 Glossary, ASC Master Glossary]

— the analysis regarding the income statement classification of settlement proceeds; and
— that the classification depends on the relevant facts and circumstances.

The settlement of a patent infringement should be distinguished from a settlement of past due license fees. If an entity is in the business of licensing intellectual property (e.g. licensing software) and is required to pursue legal action to enforce its licensing rights, whether from an existing customer (e.g. to collect unpaid license fees – see Question F212) or from an entity that is not party to an existing contract (e.g. an unrelated entity that has obtained unauthorized use of the entity's IP – see Question F216), the settlement amount should be allocated between 'past due license fees' (which would be recognized as revenue in accordance with Topic 606) and any settlement gain. Generally, this would be based on the stand-alone selling price of the license with amounts in excess of the stand-alone selling price of the license being characterized as a settlement gain.

However, in other scenarios, one entity (Entity A) may infringe on another entity's (Entity B) patent that Entity B does not license to other parties as part of its ongoing major or central operations. For example, Entity A may infringe upon Entity B's patent when it develops a similar consumer product to one previously developed by Entity B. In those scenarios, because licensing is not part of the entity's (Entity B's) ongoing major or central operations, the settlement proceeds would generally not be characterized as license revenue.

Observation

We believe that the considerations outlined in an SEC staff speech (Eric C. West) at the 2007 AICPA National Conference on Current SEC and PCAOB Developments are still relevant in analyzing the substance of these arrangements. That SEC staff speech discussed various matters including potential elements of the arrangement, allocation of consideration, classification of the settlement (including treatment of payment to customers) and consideration received by a customer as a result of a settlement. The SEC staff noted that accounting for litigation settlements requires judgment in determining the elements within the arrangement, when to recognize those elements and the value to allocate to them.

Question A65

How should an entity evaluate whether using a portfolio approach would materially differ from applying Topic 606 on a contract-by-contract basis?

Interpretive response: Selecting the size and composition of a portfolio requires judgment. An entity should take a reasonable approach to determine the appropriate portfolios, but it does not necessarily need to quantitatively assess each potential outcome.

An entity may combine quantitative and qualitative analyses of assumptions and underlying data to establish a reasonable expectation that the effects of applying the guidance to a particular portfolio of contracts would not materially differ from applying the guidance to each individual contract within that portfolio. [ASU 2014-09.BC69]

Although Topic 606 does not provide specific guidance, the following factors could be relevant to the analysis.

- Type of customer – e.g. size, location, duration as a customer, creditworthiness, type of business.
- Contract terms – e.g. delivery terms, contract duration, cancellation terms, rights of return, nature of transaction price consideration.
- Performance obligations – e.g. product warranties, material rights, discounts and incentives, over-time or point-in-time obligations.
- Volume of contracts with similar characteristics – e.g. high volume of contracts with established history over time.

Question A66

Can a portfolio approach be used for some aspects of the revenue model, but not all?

Interpretive response: Yes. Although there may be benefits of applying the portfolio approach to all aspects of the revenue model, the portfolio approach may be used for only some aspects or performance obligations. For example, it could be used to account for rights of return even though other types of estimates and judgments required under the revenue model are made on a contract-by-contract basis.

Scope of licensing implementation guidance and illustrations

Excerpt from ASC 606-10

>> Licensing

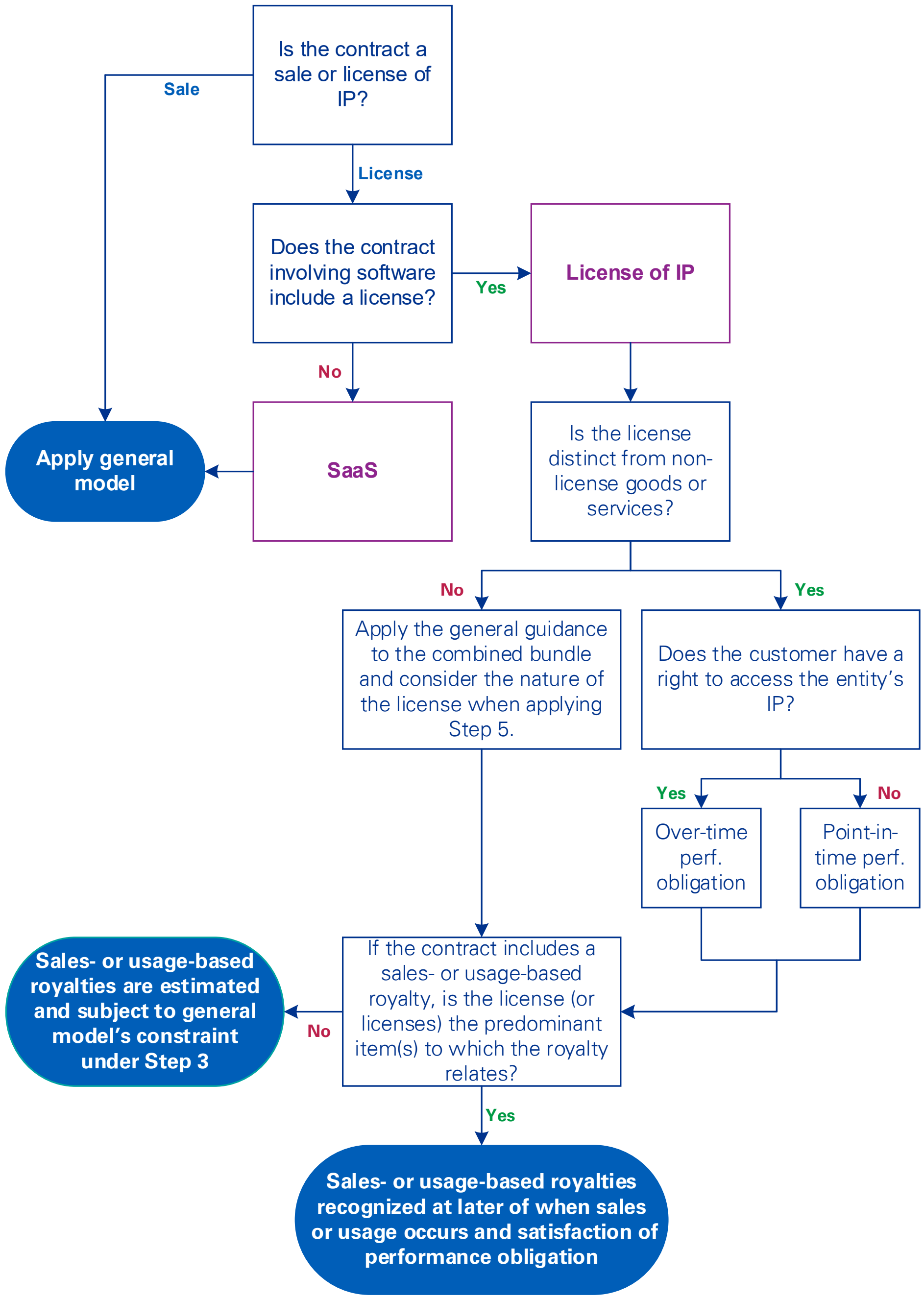
55-54 A license establishes a customer's rights to the intellectual property of an entity. Licenses of intellectual property may include, but are not limited to, licenses of any of the following:

a. Software (other than software subject to a hosting arrangement that does not meet the criteria in paragraph 985-20-15-5) and technology
b. Motion pictures, music, and other forms of media and entertainment
c. Franchises
d. Patents, trademarks, and copyrights.

Topic 606 provides implementation guidance specific to licenses of IP. The licensing implementation guidance (paragraphs 606-10-55-54 through 55-65B) and related examples (Examples 54 through 61B in paragraphs 606-10-55-362 through 55-399O) apply only to licenses of software that meet the criteria in paragraph 985-20-15-5. Even if a contract states that a license to software is part of the arrangement, a license does not exist for accounting purposes, and the licensing implementation guidance (including the related examples) does not apply, when those criteria are not met. Instead, the contract is for SaaS, to which the licensing implementation guidance does *not* apply.

As will be outlined throughout this publication, determining whether an arrangement involving software includes a license of IP for accounting purposes, and therefore whether the licensing implementation guidance applies, will significantly affect the accounting for that arrangement.

The following decision tree summarizes how Topic 606 applies to arrangements that include a software license as compared to arrangements that do *not* include a software license, such as SaaS arrangements.



Under Topic 606, the licensing implementation guidance does not apply to SaaS arrangements – i.e. arrangements for which the hosted software does not meet the criteria in paragraph 985-20-15-5. SaaS arrangements are accounted for as service obligations, not arrangements that transfer a license to IP. This means that, as outlined in the preceding diagram, entities entering into SaaS arrangements will apply the *general* revenue guidance – i.e. rather than the licensing implementation guidance – on:

- whether to recognize revenue over time or at a point in time;
- how to measure progress toward satisfaction of the performance obligation (when revenue is recognized over time); and
- variable consideration (e.g. usage- or transaction-based fees).

It is important to highlight, however, that the licensing implementation guidance will come into play, to differing extents depending on the facts and circumstances, if a combined performance obligation (i.e. a performance obligation comprised of two or more promised goods or services) includes a software license and a SaaS element (Question C310 discusses considerations in evaluating whether a software license and a SaaS element are separate performance obligations in a contract that includes *both*). For example, an entity will generally need to consider the nature of the software license (i.e. as a right to *use* the entity's intellectual property, which would be satisfied at a point in time if it were distinct, or a right to access the entity's intellectual property, which would be satisfied over time) that is part of the combined performance obligation in determining how to account for that performance obligation. And if there is a sales- or usage-based royalty, the licensing implementation guidance on such royalties will apply if the software license is the predominant item to which the royalty relates (the general guidance on variable consideration will apply if it is not). The following chapters will further address each of these issues:

— *Chapter C – Step 2: Identify the performance obligations in the contract* addresses considerations for determining whether a software license and a SaaS element are separate performance obligations (see Question C310).
— *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation* addresses:
  – identifying the nature of a software license;
  – identifying the nature of a combined performance obligation that includes a license and other goods or services (e.g. a SaaS, professional services or PCS element); and
  – the applicability of the exception for sales- or usage-based royalties for licenses of IP.

Excerpt from ASC 985-20

> Software Subject to a Hosting Arrangement

15-5 The software subject to a **hosting arrangement** is within the scope of this Subtopic only if both of the following criteria are met:

a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

15-6 For purposes of criterion (a) in the preceding paragraph 985-20-15-5, the term *significant penalty* contains two distinct concepts:

a. The ability to take delivery of the software without incurring significant cost
b. The ability to use the software separately without a significant diminution in utility or value.

15-7 If the software subject to a hosting arrangement never meets the criteria in paragraph 985-20-15-5, then the software is utilized in providing services and is not within the scope of this Subtopic and, therefore, the development costs of the software should be accounted for in accordance with Subtopic 350-40 on internal-use software (see also paragraph 985-20-55-2).

In many arrangements that involve the customer's use of the entity's software, the customer does not host the software – that is, the customer does not download the software on to servers or computers that it owns or leases. Rather, the software is hosted by the software entity/SaaS provider or a third party. The software entity/SaaS provider will make the functionalities of the software available to the customer through the internet or a dedicated transmission line and will run the software application on either its own or a third party's hardware. In such arrangements, the question arises as to whether the arrangement includes a software license or whether the customer, instead, is receiving 'software-as-a-service' (SaaS). These arrangements may or may not include a license of the software (explicitly or implicitly) and the customer may or may not have the option to take possession of the software.

Paragraph 606-10-55-54(a) states that, even in a contract that relies upon software for its fulfillment, a software license is *not* present in that arrangement unless the criteria in paragraph 985-20-15-5 are met. Those criteria are:

— the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty; and

— it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the entity to host the software.

With respect to the criterion (a), the notion of 'without significant penalty' includes two concepts:

— the ability of the customer to take delivery of the software without incurring significant costs;

— the ability of the customer to use the software separately (i.e. on the customer's own hardware or that of a third party) without a significant diminution in utility or value of the software.

Meanwhile, criterion (b) is met if:

— the customer has the IT infrastructure to host the software or is readily able to obtain such IT infrastructure (e.g. the customer can obtain the necessary hardware, and potentially services, from a third party); or

— there are unrelated, third-party hosting services readily available to the customer.

If either criterion in paragraph 985-20-15-5 is not met, the arrangement does not include a software license; rather, the entity is providing SaaS. As outlined above, SaaS is not subject to the licensing implementation guidance in Topic 606.

As the industry has evolved, and continues to evolve, it is increasingly common for arrangements to include *both* an on-premise software element and a SaaS element (e.g. a license to an on-premise software application – including one that is hosted, but meets the requirements in paragraph 606-10-55-54(a) – and a SaaS element or a SaaS application with an 'offline' mode). These arrangements are often referred to as 'hybrid SaaS' or 'hybrid cloud' arrangements. Question C310 addresses what an entity should consider in determining whether the on-premise element and the SaaS element are distinct from each other in a hybrid SaaS (hybrid cloud) arrangement. If the on-premise and SaaS elements are *not* distinct from each other, the entity will generally account for the combined performance obligation (comprised of the on-premise and the SaaS elements) as a single *service*.

The diagram below illustrates the two paragraph 985-20-15-5 criteria, and Questions A70 – A120 address application questions surrounding those criteria.

Criterion (a):
The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.

'Without significant penalty' refers to:

- ability to take delivery without incurring significant cost; and
- ability to use the software separately without a significant reduction in utility or value.

+

Criterion (b):
It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the entity to host the software.

Criterion (b) is met if either:

- the customer has the IT infrastructure to host the software or is readily able to obtain such IT infrastructure; or
- there are unrelated, third party hosting services readily available to the customer.

- **If both criteria met » software license**
- **If either criterion not met » SaaS arrangement**

Question A70

Can the customer have a 'contractual right to take possession of the software at any time during the hosting period' if no such right is explicitly provided for in the contract (or in any contract or other agreement that is combined with that contract)?

Interpretive response: Yes. If the customer has an enforceable right to take possession of the software as a matter of law, the fact that the contract does not explicitly provide for that right in writing does not matter. It may be the case in some jurisdictions in which the entity contracts that the relevant laws or regulations, or the entity's customary business practices, provide the customer with that enforceable right even if neither the customer, nor the entity, intended for the contract to convey that right.

Question A80

Criterion (a) in paragraph 985-20-15-5 requires the customer to have the right to take possession of the software at any time during the hosting period without significant penalty. How should entities interpret 'at any time' in the context of this criterion?

Interpretive response: We believe that judgment will need to be applied to the specific facts and circumstances in order to determine whether this part of the criterion in paragraph 985-20-15-5(a) is met, and that a contractual right to take possession of the software (see Question A70) can meet that criterion even if the customer did not have the right to take possession at every single point in time of the hosting arrangement. The following table provides our analysis of some common situations encountered in practice.

Scenario	Conclusion
The customer has the right to take possession of the software *at every single point in time during the contract.*	The customer has the contractual right to take possession of the software *at any time* during the hosting period.
The customer has the right to take possession of the software throughout the hosting arrangement except for: — the last few days of the hosting arrangement (or months of a long-term hosting arrangement); or — a few days of each month (e.g. the last five days or the first five days of each month) in a long-term hosting arrangement.	The customer has the right to take possession of the software at any time during the hosting period; the restrictions described are not substantive.
The customer has the right to take possession of the software either: — only at sporadic or specific points in time (e.g. only on the last day of each year) during the hosting arrangement; or — only upon the occurrence of a contingent event that is neither within the control of the customer to make occur, nor reasonably certain to occur.	The customer does not have the right to take possession of the software at any time during the hosting period and, therefore, the arrangement does not include a software license (i.e. it is a SaaS arrangement).
The customer has the right to take possession of the software if the entity materially breaches the contract.	The customer does not have the right to take possession of the software at any time during the hosting period and,

Scenario	Conclusion
	therefore, the arrangement does not include a software license (i.e. it is a SaaS arrangement).

Question A90

Paragraph 985-20-15-6(a) explains that having the right to take possession of the software 'without significant penalty' includes 'the ability to take delivery of the software without incurring significant cost'. What costs should an entity consider in determining if there is a significant penalty and what would be considered significant?

Interpretive response: The focus of the analysis in this regard should be on direct and incremental costs. The mere existence of some level of cost in connection with taking possession of the software would not, by itself, result in a 'significant penalty'.

Direct and incremental costs include forfeited hosting (or other upfront) fees, termination fees or penalties incurred to cancel the hosting arrangement. Penalties include hosting fees the customer is required to continue to pay to the entity after termination of the entity's hosting services. Similarly, if the customer would incur significant 'switching costs', that would also generally constitute a penalty. For example, if the customer would be required to invest in the IT infrastructure to host/support the software but would not receive a commensurate reduction in hosting fees under the contract, that deficiency would generally be considered a penalty from taking possession of the software.

Although determining whether penalty costs are significant will require judgment, we believe that costs that exceed 10% of the total contract fees (e.g. software license fees as well as any initial, non-cancellable PCS and/or hosting services fees) usually would be a strong indicator that the costs are significant. However, all facts and circumstances should be considered, and a penalty of less than 10% might be considered significant if it creates a substantial disincentive for the customer to take possession of the software.

Question A100

What considerations should be made in determining whether the customer can use the software separately from the entity's hosting services without a significant diminution in utility or value when evaluating criterion (b) in paragraph 985-20-15-6?

Interpretive response: The determination of whether a customer in a hosting arrangement will suffer a significant diminution in utility or value of the software if it takes possession of the software may depend on a variety of factors, including, but not limited to, the following.

— Whether taking possession of the hosted software negates the customer's right to receive one or more specified upgrades or unspecified updates or upgrades that are considered integral to maintaining the utility of the software (see Question C170). If the customer forfeits its right to receive integral updates or upgrades by taking possession of the software, this would indicate the customer will incur a significant diminution in utility and value of the software from terminating the hosting services.

— Whether there are significant features or functionalities available to the customer when the software is hosted by the entity that would no longer be available to the customer if the customer took possession of the software. This would indicate the customer will incur a significant diminution in utility or value of the software from terminating the hosting services.

— Whether incremental resources must be obtained by the customer to maintain the functionality of the software if the customer elects to take possession of the software. For example, the customer may need to obtain an additional software product (e.g. relational database software) or implement additional manual procedures to compensate for a loss of utility in the software included in the hosting arrangement. The need to obtain incremental resources to maintain the functionality of the software would indicate that the customer will experience a significant reduction in utility of the software from taking possession of it.

— If the customer has the ability to transfer the hosting services to another provider, while retaining the right to future specified or unspecified upgrades and enhancements of the software, that may be an indicator that it would not incur a significant diminution of utility or value from taking possession of the software.

However, we believe that a significant diminution in utility or value from taking possession of the software does not impose a 'significant penalty' on the customer if:

— there are readily available resources (e.g. on-premise software, third-party hosting services or hardware that is sold separately) that can replace the significant diminution in utility or value the customer would experience from taking possession of the software; *and*

— the cost to obtain those readily available resources is comparable to the cost of the hosting services they will replace.

Importantly, *even if both of the criteria in the preceding paragraph are met, the customer may still incur a 'significant penalty'*. For example, as outlined in Question A90, if the customer has to pay a significant termination fee, forfeit a significant upfront fee or continue to pay the entity hosting fees, the fact that it can replace a significant diminution in utility or value at a cost comparable to the software entity's hosting services does not mean the customer would not incur a significant penalty from taking possession of the software.

Example A100.1
Software license or SaaS (1)

Customer enters into a three-year contract with ABC Corp. to access ABC's software (Product H) in a hosting arrangement. The contract requires an upfront payment of $500,000, and also includes a stated monthly fee of $25,000 for the hosting services provided by ABC.

In addition to these basic facts:

— Customer has the enforceable right under the contract to take possession of the software at any time for no additional fee and, if it does so, will no longer be required to pay the $25,000 monthly fee for the hosting services.

— If Customer takes possession of Product H, it loses the right to future unspecified updates, upgrades and enhancements. However, Product H is a mature product that ABC updates infrequently and updates are typically minor in nature and not integral to maintaining the utility of Product H.

— Customer has significant and established IT capacity and resources such that the incremental costs of electing to take possession of the software from ABC would not be significant in comparison to the hosting service fees it would avoid.

— The stated hosting fees are equal to the observable stand-alone selling price for those services.

ABC determines that the contract includes a license to the Product H software and hosting services. In accordance with paragraph 985-20-15-5:

— Customer has the contractual right to take possession of the Product H software at any time, and can do so without incurring a significant penalty. ABC concludes that Customer will not incur a significant penalty if it takes possession of the software because:

  – there is no fee or penalty for terminating the hosting services;

  – Customer does not have to continue to pay for the hosting services after they are terminated; and

  – despite the fact that Customer will lose the right to obtain future updates, upgrades and enhancements, those items are not integral to maintaining the utility of Product H outside of the hosting environment because Product H is a mature software product. As such, Customer will not experience a significant diminution in utility or value of Product H from taking possession of Product H.

— It is feasible for Customer to run (i.e. host) the Product H software on its own because of its significant and established IT capacity and resources. Because Customer has a significant and established IT capacity it will incur no (or minimal) incremental costs to host the Product H software.

Example A100.2
Software license or SaaS (2)

Assume the same basic facts as in Example A100.1. In addition:

— Customer has the enforceable right under the contract to take possession of the software at any time for no additional fee and, if it does so, will no longer be required to pay the $25,000 monthly fee for the hosting services.

— There are third-party hosting service providers that can host the Product H software for Customer for a comparable monthly fee as the hosting services provided by ABC.

— All of the core functionality of Product H will remain available to Customer if they choose to take possession of the Product H software. However, significant search and data reporting functionalities are available to Customer only when the Product H software is connected to ABC's proprietary, hosted database, which is only accessible to customers using Product H within ABC's hosting environment.

ABC determines that the contract does *not* include a license to the Product H software and, therefore, *is a SaaS arrangement*. This is because, while it is feasible for Customer to have a third-party host software Product H in place of ABC and Customer has the contractual right to take possession of the Product H software at any time, *it cannot take possession of the software without incurring a 'significant penalty'.*

ABC concludes that Customer will incur a significant penalty if it takes possession of the Product H software because:

— Customer will lose access to ABC's proprietary, hosted database, without which significant functionalities will not be available to Customer; and

— there are no other readily available resources Customer could use to replace those functionalities because ABC's database is proprietary and only available to customer using Product H within ABC's hosting environment.

Example A100.3
Software license or SaaS (3)

Assume the same basic facts as in Examples A100.1 and A100.2.

In addition to the basic facts, the following additional facts are relevant:

— Customer has the enforceable right under the contract to take possession of the software at any time.

— The contract requires that Customer provide six months' notice to terminate the hosting services. That is, on Day 1, if Customer takes possession of the Product H software and terminates the hosting services accordingly, it will still have to pay $150,000 in hosting services fees ($25,000 × 6 months).

ABC determines that the contract does not include a license to the Product H software and, therefore, is a SaaS arrangement. This is because, while Customer has the contractual right to take possession of the Product H software at any time, *it cannot do so without incurring a 'significant penalty'*.

ABC concludes that Customer will incur a significant penalty if it takes possession of the Product H software based on the six-month 'notice period'. The six-month notice requirement constitutes a significant penalty because Customer must pay this amount without receiving benefit for the fees paid (i.e. it will receive no services in return for those fees) and because that amount of $150,000 exceeds 10% of the fees under the contract ($500,000 upfront fee + $900,000 in hosting services fees).

Comparison to legacy US GAAP

The criteria for determining whether a hosting arrangement includes a software license was not changed by ASU 2014-09 or any of the subsequent revenue-related ASUs. Consequently, the analysis of whether a hosting arrangement includes a software license under Topic 606 should be relatively consistent with the analysis of whether a hosting arrangement includes a software element under legacy US GAAP.

Question A110

If software will be hosted on entity servers that are leased by the customer, is there a software license?

Interpretive response: Yes. Hosting software on entity servers that are leased by the customer is no different from hosting the software on servers *owned* by the customer. In either case, there is a software license because the customer *has* possession of the software.

Importantly, it does not matter *why* a lease is determined to exist. For example, in some cases, customers will explicitly lease equipment from the entity. In those cases, there is also typically an explicit software license (i.e. the intent of the arrangement is to grant the customer a software license). However, in other cases, an 'embedded lease' may exist under Topic 842 (or Topic 840, if Topic 842 has not yet been adopted) even if there is no explicit lease agreement or any lease mentioned in the contract with the customer. For example, under the leases guidance a customer may be leasing a server from the software entity if the server is dedicated to the customer (i.e. the server is not used to host software or provide services for any other customer) even if there is no mention of a lease in the contract and that server is housed in the entity's data center (e.g. the server may be viewed by the entity as merely part of the data center).

Because the entity's accounting for the contract may differ significantly depending on whether there is or is not a software license in the arrangement, it will be important for entities that enter into hosting arrangements (including those that may be characterized solely as SaaS arrangements) with customers to consider whether they are leasing the equipment used to host the software to the customer. And if so, the entity should account for the arrangement as one that includes a software license (i.e. rather than as a SaaS arrangement).

Entities should be aware that the lease identification guidance differs between Topic 842 and Topic 840. Therefore, the analysis of whether a lease exists, though not *necessarily* the result of that analysis, will change upon the adoption of Topic 842.

Question A120

Is the conclusion about whether a software license is present in a contract with a customer affected by the customer's or the software entity's use of a third-party hosting service?

Interpretive response: Determining whether a contract includes a software license is not affected by whether the customer uses a third party to host the entity's software or whether the entity engages a third party to host the software.

The fact that the customer uses a third-party hosting provider, or would be required to use a third-party hosting provider if it were to exercise its right to take possession of the software in a hosting arrangement, rather than hosting the software on its own IT equipment, does not affect the conclusion that would otherwise be reached by the entity about whether the contract includes a software license.

Similarly, the fact that the entity uses a third party to host its software, rather than hosting the software in its own data center, should not change the conclusion that would otherwise be reached as to whether the contract includes a software license from that which would be reached if the entity were hosting the software itself; this includes the possibility that the customer *could* be deemed to be leasing (likely sub-leasing from the entity) the third party's equipment.

Example A120.1

Software license or SaaS

ABC Corp.'s typical customer contract provides customers with the right to use its software (Product J) on a SaaS basis. ABC hosts Product J using a third-party hosting provider (XYZ), rather than hosting Product J in its own data center. ABC's customers are not permitted to take possession of Product J. ABC manages and controls the hosting services from XYZ associated with Product J, i.e. ABC has the contract with XYZ for the hosting services. ABC bills customers on a monthly or quarterly basis, which includes proportional reimbursement of ABC's actual costs for the XYZ hosting services related to Product J.

Customer A (an existing customer of XYZ) has expressed an interest in deploying Product J in its own XYZ hosting environment, rather than ABC's, to take advantage of Customer A's favorable contract terms and pricing arrangement with XYZ – i.e. Customer A will realize savings in actual hosting costs by structuring the arrangement in this manner. Notwithstanding Customer A's desire to achieve these cost savings, it is the intent of both ABC and Customer A to have ABC manage and control the hosting of Product J in the same manner as ABC manages and controls its typical arrangements; this includes the provision that Product J cannot be removed from the XYZ hosting environment.

To permit this arrangement, a provision has been added to Customer A's agreement with XYZ to give ABC access, billing, control and management rights/responsibilities for a separate Customer A account with XYZ that is dedicated to hosting Product J. Customer A is not permitted to take possession of the Product J software or transfer the software to another hosting provider or another Customer A account with XYZ.

Notwithstanding the specifics of the new contractual provision, ABC determines that its contract with Customer A includes a license to Product J (i.e. that the contract is not a SaaS arrangement), and does *not* include hosting services. This is because under its contract with Customer A, ABC's performance obligations do not include hosting Product J for Customer A because XYZ is providing the hosting services to Customer A, not ABC. In contrast, under ABC's typical customer arrangements, even though XYZ also hosts Product J, ABC is the principal to the customer arrangement for those hosting services. ABC is not a principal in the Customer A arrangement with XYZ.

Because ABC concludes that there is a license to Product J in the Customer A arrangement, that license is subject to the licensing implementation guidance in Topic 606. ABC transfers control of the license to Customer A when ABC delivers the license to Customer A's hosting agent (XYZ) – i.e. assuming the license term has begun and other considerations outlined in *Chapter F – Recognize revenue when (or as) the entity satisfies a performance obligation* have been satisfied.

In addition, ABC will need to consider whether its promises to provide technical support and unspecified updates, upgrades and enhancements (which it will provide to Customer A in connection with Product J), and to manage Customer A's hosting account for Product J are separate performance obligations (see *Chapter C – Step 2: Identify the performance obligations in the contract*).

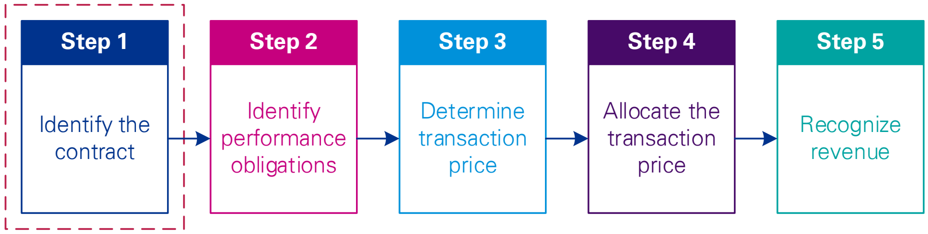
B. Step 1: Identify the contract with the customer

Questions and Examples

Overview

Determining whether a contract exists

Questions & answers



Overview

Topic 606 identifies when a contract with a customer exists and, therefore, is accounted for under Topic 606; how to account for consideration received before concluding that a contract exists; and when two or more contracts should be combined for purposes of applying the model.

Excerpt from ASC 606-10

20 Glossary

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

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.

> Identifying the Contract

25-1 An entity shall account for a contract with a customer that is within the scope of this Topic only when all of the following criteria are met:

a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.
b. The entity can identify each party's rights regarding the goods or services to be transferred.
c. The entity can identify the payment terms for the goods or 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 substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C). In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price

stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 606-10-32-7).

25-2 A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

25-3 Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations. In evaluating the criterion in paragraph 606-10-25-1(e), an entity shall assess the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectibility of the consideration promised in the contract for all of the promised goods or services (see paragraphs 606-10-55-3A through 55-3C). However, if an entity determines that all of the criteria in paragraph 606-10-25-1 are met, the remainder of the guidance in this Topic shall be applied to all of the promised goods or services in the contract.

25-4 For the purpose of applying the guidance in this Topic, 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). A contract is wholly unperformed if both of the following criteria are met:

a. The entity has not yet transferred any promised goods or services to the customer.
b. The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

25-5 If a contract with a customer meets the criteria in paragraph 606-10-25-1 at contract inception, an entity shall not reassess those 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, an entity would reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C).

25-6 If a contract with a customer does not meet the criteria in paragraph 606-10-25-1, an entity shall continue to assess the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met.

25-7 When a contract with a customer does not meet the criteria in paragraph 606-10-25-1 and an entity receives consideration from the customer, the entity shall recognize the consideration received as **revenue** only when one or more of the following events have occurred:

a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or define, of the consideration promised by the customer has been received by the entity and is nonrefundable.
b. The contract has been terminated, and the consideration received from the customer is nonrefundable.
c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

25-8 An entity shall recognize the consideration received from a customer as a liability until one of the events in paragraph 606-10-25-7 occurs or until the criteria in paragraph 606-10-25-1 are subsequently met (see paragraph 606-10-25-6). Depending on the facts and circumstances relating to the contract, 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 shall be measured at the amount of consideration received from the customer.

>> Assessing Collectibility

55-3A Paragraph 606-10-25-1(e) requires an entity to 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 goods or services that will be transferred to the **customer**. The assessment, which is part of identifying whether there is a **contract** with a customer, is based on whether the customer has the ability and intention to pay the consideration to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer. The objective of this assessment is to evaluate whether there is a substantive transaction between the entity and the customer, which is a necessary condition for the contract to be accounted for under the revenue model in this Topic.

55-3B The collectibility assessment in paragraph 606-10-25-1(e) is partly a forward-looking assessment. It requires an entity to use judgment and consider all of the facts and circumstances, including the entity's customary business practices and its knowledge of the customer, in determining whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that the entity expects to transfer to the customer. The assessment is not necessarily based on the customer's ability and intention to pay the entire amount of promised consideration for the entire duration of the contract.

55-3C When assessing whether a contract meets the criterion in paragraph 606-10-25-1(e), an entity should determine whether the contractual terms and its customary business practices indicate that the entity's exposure to credit risk is less than the entire consideration promised in the contract because the entity has the ability to mitigate its credit risk. Examples of contractual terms or customary business practices that might mitigate the entity's credit risk include the following:

a. Payment terms—In some contracts, payment terms limit an entity's exposure to credit risk. For example, a customer may be required to pay a portion of the consideration promised in the contract before the entity transfers promised goods or services to the customer. In those cases, any consideration that will be received before the entity transfers promised goods or services to the customer would not be subject to credit risk.
b. The ability to stop transferring promised goods or services—An entity may limit its exposure to credit risk if it has the right to stop transferring additional goods or services to a customer in the event that the customer fails to pay consideration when it is due. In those cases, an entity should assess only the collectibility of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer on the basis of the entity's rights and customary business practices. Therefore, if the customer fails to perform as promised and, consequently, the entity would respond to the customer's failure to perform by not transferring additional goods or services to the customer, the entity would not consider the likelihood of payment for the promised goods or services that will not be transferred under the contract.

An entity's ability to repossess an asset transferred to a customer should not be considered for the purpose of assessing the entity's ability to mitigate its exposure to credit risk.

>>> Example 1—Collectibility of the Consideration

>>>> Case A—Collectibility Is Not Probable

55-95 An entity, a real estate developer, enters into a contract with a customer for the sale of a building for $1 million. The customer intends to open a restaurant in the building. The building is located in an area where new restaurants face high levels of competition, and the customer has little experience in the restaurant industry.

55-96 The customer pays a nonrefundable deposit of $50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95 percent of the promised consideration. The financing arrangement is provided on a nonrecourse basis, which means that if the customer defaults, the entity can repossess the building but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed.

55-97 The entity concludes that not all of the criteria in paragraph 606-10-25-1 are met. The entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the entity will collect substantially all of the consideration to which it is entitled in exchange for the transfer of the building. In reaching this conclusion, the entity observes that the customer's ability and intention to pay may be in doubt because of the following factors:

a. The customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience).

b. The customer lacks other income or assets that could be used to repay the loan.
c. The customer's liability under the loan is limited because the loan is nonrecourse.

55-98 The entity continues to assess the contract in accordance with paragraph 606-10-25-6 to determine whether the criteria in paragraph 606-10-25-1 are subsequently met or whether the events in paragraph 606-10-25-7 have occurred.

>>>> Case B—Credit Risk Is Mitigated

55-98A 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.

55-98B 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.

55-98C 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 9 months. 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.

55-98D In assessing whether the contract meets the criteria in paragraph 606-10-25-1, the entity assesses 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 in accordance with paragraph 606-10-55-3B and its business practice of stopping service in response to customer nonpayment in accordance with paragraph 606-10-55-3C. 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.

55-98E 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 criterion in paragraph 606-10-25-1(e) because it is probable that the customer will pay substantially all of the consideration to which the entity is entitled for the services 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 criteria in paragraph 606-10-25-1(a) through (d) are met, the entity would apply the remaining guidance in this Topic to recognize revenue and only reassess the criteria in paragraph 606-10-25-1 if there is an indication of a significant change in facts or circumstances such as the customer not making its required payments.

>>>> Case C—Credit Risk Is Not Mitigated

55-98F The same facts as in Case B apply to Case C, except that the entity's history with this class of customer indicates that there is a risk that the customer will not pay substantially all of the consideration for services received from the entity, including the risk that the entity will never receive any payment for any services provided.

55-98G In assessing whether the contract with the customer meets the criteria in paragraph 606-10-25-1, the entity assesses whether it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. This includes assessing the entity's history with this class of customer and its business practice of stopping service in response to the customer's nonpayment in accordance with paragraph 606-10-55-3C.

55-98H At contract inception, the entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the customer will pay substantially all of the consideration to which the entity will be entitled under the contract for the services that will be transferred to the customer. The entity concludes that not only is there a risk that the customer will not pay for services received from the entity, but also there is a risk that the entity will never receive any payment for any services provided. Subsequently, when the customer initially pays for one month of service, the entity accounts for the consideration received in accordance with paragraphs 606-10-25-7 through 25-8. The entity concludes that none of the events in paragraph 606-10-25-7 have occurred because the contract has not been terminated, the entity has not received substantially all of the consideration promised in the contract, and the entity is continuing to provide services to the customer.

55-98I Assume that the customer has made timely payments for several months. In accordance with paragraph 606-10-25-6, the entity assesses the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met. In making that evaluation, the entity considers, among other things, its experience with this specific customer. On the basis of the customer's performance under the contract, the entity concludes that the criteria in 606-10-25-1 have been met, including the collectibility criterion in paragraph 606-10-25-1(e). Once the criteria in paragraph 606-10-25-1 are met, the entity applies the remaining guidance in this Topic to recognize revenue.

>>>> Case D—Advance Payment

55-98J An entity, a health club, enters into a one-year membership with a customer of low credit quality. The transaction price of the contract is $120, and $10 is due at the beginning of each month. The standalone selling price of the monthly service is $10.

55-98K On the basis of the customer's credit history and in accordance with the entity's customary business practice, the customer is required to pay each month before the entity provides the customer with access to the health club. In response to nonpayment, the entity's customary business practice is to stop providing service to the customer upon nonpayment. The entity does not have exposure to credit risk because all payments are made in advance and the entity does not provide services unless the advance payment has been received.

55-98L The contract meets the criterion in paragraph 606-10-25-1(e) because it is probable that the entity will collect the consideration to which it will be entitled in exchange for the services that will be transferred to the customer (that is, one month of payment in advance for each month of service).

Determining whether a contract exists

Definition of a contract

Topic 606 defines a 'contract' as an agreement between two or more parties that creates enforceable rights and obligations and specifies that enforceability is *a matter of law*. Consequently, the assessment of whether a contract exists does not focus on the form of the contract. Contracts can be written, oral or implied by an entity's customary business practices, depending on the relevant laws and regulations under which the contract is governed.

The assessment of whether a contract exists may require significant judgment in some jurisdictions or for some arrangements and may result in different conclusions for similar contracts in different jurisdictions. In some cases, the parties to an oral or an implied contract (in accordance with customary business practices) may have agreed to fulfill their respective obligations. In cases of significant uncertainty about enforceability (e.g. oral or an implied contract), a written contract and legal interpretation by qualified counsel may be required to support a conclusion that the parties to the contract have approved and are committed to perform their respective obligations. An entity should assess whether the parties intend to be bound by the terms and conditions of the contract. This evaluation may include an assessment of an entity's customary business practices and past practice of what has been enforced.

Wholly unperformed contracts

A contract does not exist for accounting purposes if each party to the contract has the unilateral right to terminate a 'wholly unperformed' contract without compensating the other party (or parties). A contract is wholly unperformed if two criteria are met:

— 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.

Contract identification criteria

The Boards decided to supplement the definition of a contract by specifying additional criteria beyond legal enforceability that must be met for an entity to conclude a contract exists in accordance with Topic 606 and can apply the revenue model in Topic 606 to that contract. The Boards decided that when some or all of those criteria are not met, it is questionable whether the contract establishes enforceable rights and obligations. Therefore, a contract with a customer is subject to the revenue model in Topic 606 only when it is legally enforceable and meets all of the following criteria.

A contract exists if...

- **Collection of consideration is probable**
- **Rights to goods or services and payment terms can be identified**
- **It has commercial substance**
- **It is approved and the parties are committed to their obligations**

Two of those criteria are that (1) the parties must have approved the contract and be committed to performing their respective obligations and (2) each party's rights with respect to the goods and services, as well as the payment terms, can be identified. At the financial reporting date, a contract may still be (a) subject to contingencies (such as a substantive additional reviews yet to occur and authorizations yet to be obtained), (b) in a preliminary stage (such as a letter of intent) or (c) require additional negotiations and subsequent amendments or revisions. In such cases, criteria (1) and (2) are likely not met and, therefore, a contract does not exist and the revenue model in Topic 606 will not yet apply.

However, there may be scenarios in which an entity continues to provide services to a customer after expiration of a contract but during contract extension negotiations. These fact patterns are discussed in Question B60 and Example B60.1.

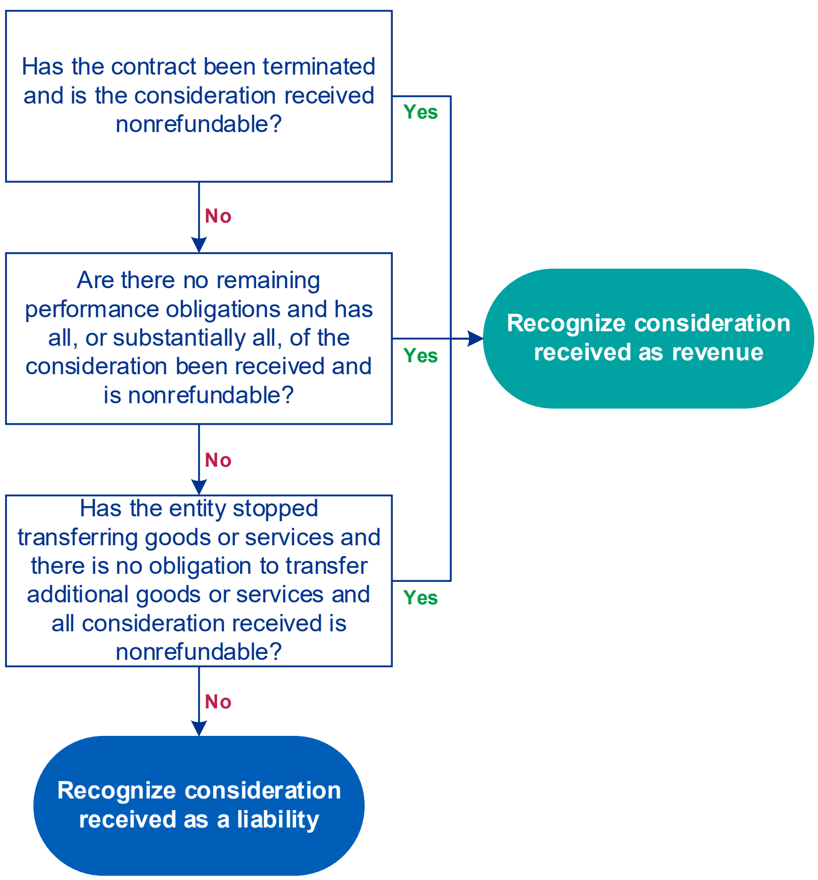
If all of the criteria to account for a contract with a customer under Topic 606 have not been met, the entity continually reassesses the arrangement against them and applies the revenue model in Topic 606 to the contract from the date on which all of the criteria are met, which may result in a cumulative effect revenue adjustment for the entity's performance to-date (e.g. to recognize revenue based on the goods or services transferred to the customer before a contract was determined to exist). In contrast, if a contract meets all of the criteria at contract inception, an entity does not reassess any of those criteria unless there is a significant change in facts and circumstances. If, on reassessment, an entity determines that the criteria are no longer met, then it ceases to apply the revenue model to the contract from that date but does not reverse any revenue previously recognized.

An entity may have a pattern of frequently renegotiating the terms of the contract or have a history of providing concessions to the customer. Typically, such a pattern or history will not affect whether enforceable rights and obligations exist before the renegotiation or concession, or prevent the parties from identifying those rights and obligations, and therefore will not affect whether there is a contract between the parties within the scope of the revenue model. Rather, subsequent renegotiations would follow the contract modification guidance (see *Chapter G – Contract modifications*) and a pattern of granting concessions would affect either (or both) the entity's identification of the promised goods or services in the contract (see Question C90) or its determination of the transaction price for the contract (see Question D130).

However, we believe it is possible that in very unusual circumstances (e.g. significant actions that are unpredictable), an entity's pattern or history could be of such a nature that the entity would not be able to conclude the parties to the contract can identify all of their respective rights and obligations (including customer payment terms). In that case, the criteria in paragraph 606-10-25-1 would not be met and a contract within the scope of the revenue model would not yet exist.

Consideration received from a customer before meeting the contract identification criteria

The following flow chart describes the accounting for consideration received from a customer when the criteria for contract existence in Topic 606 are not met (see paragraph 606-10-25-7). This is also referred to as the alternative model.



Comparison to legacy US GAAP

Legacy US GAAP software revenue recognition guidance specified that, if a software entity has a customary business practice of using written contracts, persuasive evidence of the arrangement is provided only by a contract signed by both parties. Therefore, persuasive evidence of an arrangement would not exist before the final license agreement being executed by both parties. In circumstances where both parties had not executed the contract before the end of the financial reporting period, revenue would not be recognized in that period. Under Topic 606 if the placement of the customer order and shipment of the goods constitute a legally enforceable contract and the other criteria are met, then the new revenue model is applied even if it differs from an entity's customary business practices. Similar arrangements in different jurisdictions may be treated differently if the determination of a legally enforceable contract differs.

Legally enforceable rights may be less restrictive than persuasive evidence

Under the legacy guidance, an entity was required to have persuasive evidence that both parties in a transaction understand the specific nature and terms of an agreed-upon transaction. The form of persuasive evidence is required to be consistent with customary business practices, such as a signed contract.

Under Topic 606, a contract must exist but it may be oral, written or implied by customary business practices and does not have to follow a consistent form. An entity will need to consider the jurisdiction in which the transaction occurs to determine whether an agreement has created legally enforceable rights and obligations. Similar contracts may produce different results based on the jurisdiction. Therefore, it may be prudent to receive legal advice or a legal opinion in certain situations.

Collectibility

One of the criteria that must be met in order for a contract to be within the scope of the Topic 606 revenue model is that "it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer." That is, in contrast to legacy US GAAP, under which collectibility was a recognition criterion, under Topic 606, collectibility is a 'gating question' designed to prevent entities from applying the revenue model to contracts with customers who lack an ability to pay.

In making the collectibility assessment, an entity considers the customer's ability and intention (which includes assessing its creditworthiness) to pay substantially all of the amount of consideration to which the entity is entitled when it is due. This assessment is made *after* taking into consideration any price concessions that the entity may offer to the customer. Concessions are not related to a customer's ability and intention to pay the consideration in the contract; rather, concessions are typically granted in response to other factors such as competition and price pressures, sales channel overload and regulatory changes. See Question B85 for further information regarding 'substantially all.'

Judgment will be required in evaluating whether the likelihood that an entity will not receive the full amount of stated consideration in a contract gives rise to a collectibility issue or a price concession. Topic 606 includes two examples of implicit price concessions: a life science prescription drug sale (Example 2) and a transaction to provide healthcare services to an uninsured (i.e. self-pay) patient (Example 3). In both examples, the entity concludes that the transaction price is not the stated price or standard rate and that the promised consideration is variable. Consequently, an entity may need to determine the transaction price in Step 3 of the model (see *Chapter D – Step 3: Determine the transaction price*), including any price concessions, before concluding on the collectibility criterion in Step 1 of the model.

The collectibility threshold is applied to the amount to which the entity expects to be entitled in exchange for the goods and services that will be transferred to the customer, which may not be the stated contract price or the entire transaction price of the contract. The assessment considers:

- the entity's legal rights;
- past practice;
- how the entity intends to manage its exposure to credit risk throughout the contract; and
- the customer's ability and intention to pay.

The collectibility assessment is limited to the consideration attributable to the goods or services to be transferred to the customer for the non-cancellable term of the contract. For example, if a contract has a two-year term but either party can terminate after one year without penalty, then an entity assesses the collectibility of the consideration promised in the first year of the contract (i.e. the non-cancellable term of the contract).

The collectibility assessment is also limited to the consideration attributable to the goods or services the entity *will* transfer to the customer after considering its ability to mitigate any credit risk of the customer. That is, if there is a question about the customer's ability and intent to pay for all of the promised goods or services in the contract, but the entity has the ability and the intent (e.g. based on its customary business practices) to mitigate that credit risk by refusing to transfer further goods or services if the customer does not fulfill its obligations to pay the entity, the collectibility assessment is limited to whether the customer will pay substantially all of the consideration to which the entity is entitled for those goods or services the entity will transfer before it discontinues further performance.

For example, if it is not probable that a customer will pay all of the monthly fees to which a SaaS provider expects to be entitled under a three-year SaaS arrangement, the contract may still be subject to the revenue model if it *is* probable the customer will pay for some of the services (e.g. the first year of the SaaS) and SaaS provider has the ability and intent to shut off the customer's access to the SaaS in a timely manner if the customer does not pay for the service as amounts come due. However, if a contract exists the contract term for purposes of applying the Topic 606 revenue model is three years (see paragraph 606-10-25-3).

An entity may further mitigate its credit risk by requiring security deposits or advance payments. The security deposit, or requiring payments for service periods in advance, may still not make it probable that the customer will pay substantially all of the consideration for the promised goods or services in the contract, but may ensure the entity will collect substantially all of the consideration to which it expects to be entitled for the goods or services that it *will* transfer to the customer after taking into consideration its ability and intent to stop transferring goods or services as discussed in the preceding paragraph.

Term of the contract

Topic 606 is applied to the duration of the contract (i.e. the contractual period) in which the parties to the contract have presently enforceable rights and obligations. The determination of the contract term is important because it affects many other aspects of the model. For example, it may affect:

- the measurement and allocation of the transaction price
- the collectibility assessment
- the timing of revenue recognition for non-refundable upfront fees when such fees will be recognized over the contract period – i.e. rather than over a longer period when the fee provides the customer with a material right
- contract modifications
- the identification of material rights.

The following are some key considerations applicable to determining the term of a contract with a customer:

- *Consideration payable on termination can affect assessment of contract term*

  If a contract can be terminated (by either party or just by one party) only by compensating the other party (e.g. a penalty must be paid by the terminating party) and the right to compensation exists and is substantive throughout the contract period, then the contract term (i.e. the period for which enforceable rights and obligations exist for both parties) is the contractual period. However, a right to compensation may not exist, or may not be substantive, for the entire contract period. Under this circumstance, the term of the contract for revenue recognition purposes is the shorter of the specified contract period and the period up to the point at which the contract can be terminated without compensating the other party (or for which the termination penalty is no longer substantive). For example, if a SaaS provider and a customer enter into a five-year arrangement that can be canceled by the customer at any time by paying the SaaS provider a substantive compensation amount that decreases over the contract term until it reaches zero (or a non-substantive amount) at the end of the fourth year of the contract, then the contract term is four years.

  However, if a contract can be terminated without substantive compensation being paid, then its term does not extend beyond the goods and services already provided.

  In making the assessment of whether the right to compensation is substantive, an entity considers all relevant factors, including legal enforceability of the right to compensation on termination. In general, an entity's past practice of not enforcing a termination penalty (e.g. not pursuing collection of a penalty not paid by the customer) does not affect the contract term unless that past practice changes the legally enforceable rights and obligations of the parties, in which case it could affect the contract term.

— *Only the customer has a right to terminate the contract*

A customer may have the right to terminate the contract without penalty, while the entity is obligated to continue to perform until the end of a specified contract period. In that case, the contract is evaluated to determine whether the option for the customer to continue the contract (i.e. by *not* exercising its termination right) provides the customer with a material right to extend the contract beyond the date at which it can first terminate the contract. For example, a material right may exist if the contractual fee the customer will pay for periods after a termination option is at an incremental discount (see Question C410). Unless the option to continue the contract provides the customer with a material right, there is no accounting by the entity for the customer option and the contract term is presumed *not* to include periods subsequent to the date of the termination option.

— *Compensation is broader than termination payments*

A payment to compensate the other party upon termination is any amount (or other transfer of value – e.g. equity instruments) other than a payment due as a result of goods or services transferred up to the termination date. It is not restricted only to payments explicitly characterized as termination penalties.

— *Ability of either party to cancel the contract at discrete points in time may limit the term of the contract*

If an entity enters into a contract with a customer that can be renewed or canceled by either party at discrete points in time (e.g. at the end of each year) without paying substantive compensation to the other party, then the contract term is the period for which the contract cannot be canceled by either party. Upon commencement of each service period (e.g. a month in a month-to-month arrangement or a year in a year-to-year arrangement), where the entity has begun to perform and the customer has not canceled the contract, the entity generally has enforceable rights relative to fees owed for those services, and a contract exists for that period. For example, a customer may have the right to cancel a SaaS arrangement or a software post-contract customer support (PCS) arrangement at the end of each service year. If the customer does not cancel, and the entity begins providing SaaS or PCS services for the next service year following the optional termination date, generally there is a contract only for the period of time until the next optional termination date (i.e. only for the next year) and the entity has an enforceable right to payment for services provided during the period of time until the next optional termination date only.

— *Evergreen contracts*

For purposes of assessing the contract term, an evergreen contract, such as a PCS arrangement that auto-renews, that is cancellable by either party (or just the customer) each period without a substantive penalty is no different from a similar contract structured to require affirmative renewal of the contract each period (e.g. one that requires the customer to place a new order or the parties to sign a new contract). In these situations, an entity should not automatically assume a contract period that extends beyond the current period (e.g. the current month or year).

Combining contracts

Excerpt from ASC 606-10

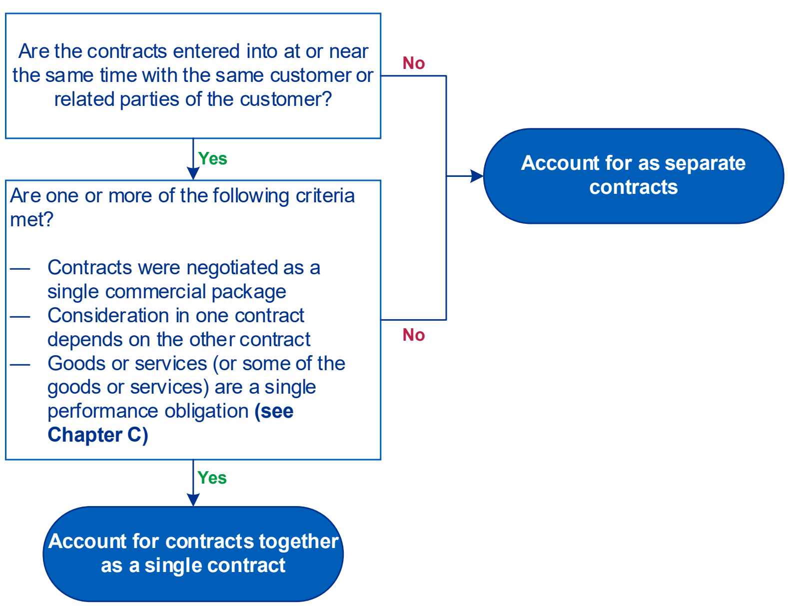
> Combination of Contracts

25-9 An entity shall 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 contracts.
c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single **performance obligation** in accordance with 606-10-25-14 through 25-22.

Determining when multiple contracts should be combined requires the use of judgment, and both the form and the substance of an arrangement must be considered in the evaluation. Often entities have continuing and multi-faceted relationships with their customers (including resellers), and this business relationship will lead to numerous signed or oral arrangements between the two parties.

The following flow chart outlines the criteria in Topic 606 for determining when an entity combines two or more contracts and accounts for them as a single contract.



Comparison to legacy US GAAP

The legacy US GAAP software revenue recognition guidance provided six indicators for an entity to consider in determining whether multiple contracts with the same customer should be combined and accounted for as a single multiple-element arrangement. Although one of the indicators was that the contracts are negotiated or executed within a short timeframe of each other, it was only an indicator to be considered *along with* five other indicators.

Under Topic 606, entities are required to combine contracts if they are *both* (a) entered into at or near the same time with the same customer (or related parties) and (b) any one of three specified criteria is met. Although the Topic 606 contract combination guidance is similar in concept to that in legacy US GAAP guidance, the use of criteria in Topic 606 versus indicators in legacy US GAAP may result in some different conclusions about whether multiple contracts are combined.

Software-specific indicators vs specified criteria

Of the six indicators in legacy US GAAP, five are similar to the three specified criteria in Topic 606 that must be considered *if* two contracts are entered into 'at or near the same time' as each other. This is also discussed in further detail in Question B210.

The indicator that negotiations are conducted jointly with two or more parties (e.g. from different divisions of the same company) to do what in essence is a single project is similar to paragraph 606-10-25-9(a) – that is, the criterion to evaluate whether the contracts are negotiated as a package with a single commercial objective.

The indicators that: (1) the fee for one or more contracts or agreements is subject to refund, forfeiture or another concession if another contract is not completed satisfactorily, and (2) the payment terms under one contract or agreement coincide with performance criteria of another contract or agreement are similar to paragraph 606-10-25-9(b) – that is, the criterion to evaluate whether the amount of consideration to be paid in one contract depends on the price or performance of the other contract.

The other two indicators in the legacy US GAAP software guidance: (1) the different elements are closely interrelated or interdependent in terms of design, technology or function, and (2) one or more elements in one contract or agreement are essential to the functionality of an element in another contract are similar to the guidance an entity evaluates in assessing whether the criterion in paragraph 606-10-25-9(c) is met.

The contracts being negotiated or executed within a short timeframe of each other is an indicator that two contracts should be combined under legacy US GAAP but is a gating question under Topic 606 – that is, an entity evaluates whether any of the three specific criteria in paragraph 606-10-25-9 are met *only if* the contracts are entered into at or near the same time (see Question B190).

Legacy US GAAP guidance applied by SaaS providers

Legacy US GAAP revenue guidance applicable to SaaS providers contains a rebuttable presumption that contracts entered into at or near the same time with the same entity or related parties are a single contract. Topic 606 does not include a similar rebuttable presumption and additional criteria must be met. Therefore, it is possible that entities could come to different conclusions under Topic 606 than they did under legacy US GAAP. However, we believe, in most cases, if none of the three additional criteria in paragraph 606-10-25-9 are met, an entity would have overcome the rebuttable presumption that existed in legacy US GAAP and, therefore, would reach the same conclusion under either Topic 606 or legacy US GAAP.

Questions & answers

Determining whether a contract exists

Question B10

If a software entity obtains signed contracts as its customary business practice does the contract have to be signed by both parties in order for a contract to exist?

Interpretive response: No. Even when a software entity obtains contracts signed by both parties as its customary business practice, a contract may exist without, or before, both parties' signatures (or even without either party's signature). This is because the assessment of whether a contract exists for purposes of applying Topic 606 focuses on whether enforceable rights and obligations exist on the parties based on the relevant laws and regulations, rather than on the form of the contract (i.e. whether it is oral, implied, electronic assent or written).

The assessment of whether there is an enforceable contract may require significant judgment in some circumstances or jurisdictions and may require the involvement of legal counsel. Further, entities should be cautious about reaching conclusions that enforceability exists if there are substantive additional reviews of the contract that have not yet occurred, or authorizations not yet obtained that could substantively alter the terms and conditions of the contract.

It will be important for entities to establish a process (and related controls) for determining when enforceability exists because the contract identification guidance in Topic 606 is not optional – that is, an entity cannot elect an accounting policy to only account for contracts with customers that have been dually-signed by both parties. For example, if a software entity transfers control of a software license on or before the reporting date (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*), but incorrectly determines whether a contract with the customer exists on or before that reporting date, revenue may be significantly over- or understated for the period.

Entities will also need to remember that for the revenue model in Topic 606 to apply to a contract, all of the criteria in paragraph 606-10-25-1 must be met, including the collectibility criterion. Therefore, even if enforceability is established, entities will have further work to do before they can begin to apply the Topic 606 revenue model to the contract.

Question B20

What should a contract with a customer describe in order to demonstrate that the parties can each identify their rights regarding the promised goods or services and the payment terms for those goods or services (i.e. that criteria b. and c. in paragraph 606-10-25-1 are met)?

Interpretive response: In general, we believe an entity should consider whether a contract includes a description of the following terms or conditions (not exhaustive):

- the products (e.g. software licenses) and/or services (e.g. SaaS, PCS, implementation services) promised in the arrangement;
- the key attributes of any software license transferred to the customer (e.g. is it perpetual or time-based, or limited as to geography or use?);
- payment terms and fees due from the customer;
- delivery terms;
- warranties, rights (e.g. return rights), obligations and termination provisions – if any; and
- any other pertinent contractual provisions (e.g. price protection, service level guarantees).

Absent the above, it may be questionable as to whether an entity would be able to identify each party's rights and obligations regarding the transfer of goods or services, including the customer's obligation to pay for the goods or services. However, the list above is not necessarily all-inclusive, nor does the absence of one or more of these items necessarily mean that criteria b. and c. in paragraph 606-10-25-1 cannot be met.

If an entity does not have a standard or customary business practice of relying on written contracts to document an arrangement, it may have other forms of written or electronic evidence to document the transaction. An entity should consider developing policies for what constitutes enforceable rights and obligations for each line of business or class of customer as they may be different for each. However, regardless of the form of documentation, the evidence should be final and include (or reference) all of the relevant terms and conditions of the arrangement.

Example B20.1

Contract approval and customary business practice, Part I

ABC Corp. licenses software and has a customary business practice of entering into written contracts with its customers that describe the terms and conditions under which customers can obtain a license to ABC's software and of delivering software upon receipt of an approved customer purchase order in writing.

Customer has established a purchasing policy that requires execution of a contract with its vendors before it will accept delivery of any software products. ABC and Customer negotiate the terms of an arrangement and execute a written master agreement that is signed by both parties on December 29, 20X4. The master agreement specifies the terms and conditions for the licensing of ABC's various software products (ABC licenses software products A-Z), including the price for each license of each software product; however, the master agreement does not commit Customer to purchase or ABC to transfer any licenses. Subsequent to the execution of the master agreement, Customer requests via an email to the account manager that ABC transfer 100 perpetual user licenses to Software Product A in accordance with the December 29 master agreement, for which it will submit a written purchase order. ABC transfers control of the licenses to Customer on December 30, 20X4 (i.e. ABC has both provided a copy of the licensed software to Customer and Customer can begin to use and benefit from the licenses – see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*). The actual purchase order from Customer is not received by ABC until January 2, 20X5.

The master agreement signed by both parties on December 29, 20X4 does not, by itself, create enforceable rights and obligations to transfer software licenses because Customer may, or may not, choose to order under the master agreement. However, that agreement, when combined with the email from Customer requesting the 100 perpetual user licenses to Product A that references the December 29 agreement, may constitute a contract in accordance with Topic 606; however, whether the customer email creates enforceable rights and obligations may vary depending on the jurisdiction. After consultation with legal counsel, ABC concludes that the master agreement in combination with the email communication from Customer establish enforceable rights and obligations between the parties with sufficient specificity to meet the contract criteria of Topic 606. Consequently, assuming that this is a single element arrangement or that the 100 user licenses to Product A are distinct from any services (e.g. PCS or professional services) in the arrangement, ABC would recognize revenue for the transfer of the 100 user licenses on December 30, 20X4.

By way of comparison, under legacy US GAAP, ABC would not have had persuasive evidence of an arrangement because ABC has a standard business practice of obtaining an approved customer purchase order in writing to evidence its arrangements (which was not received until January 2, 20X5) and, therefore, revenue related to the delivery of the 100 user licenses could not have been recognized any earlier than January 2, 20X5.

Example B20.2
Contract approval and customary business practice, Part II

Assume the same basic facts and circumstances as in Example B20.1, except that:

— the master agreement outlining the terms and conditions for the licensing of ABC's various software products (ABC licenses software products A-Z), including the price for each license of each software product, is signed, dated and returned by Customer on January 2, 20X5. ABC signed the contract on December 22, 20X4 and it was confirmed received via email by Customer the same day;

— ABC receives a written purchase order from Customer for the 100 perpetual user licenses to Product A on December 26, 20X4, referencing the master contract;

— ABC transfers control of the 100 perpetual user licenses to Customer on December 30, 20X4;

— ABC's legal counsel represents that ABC had a valid contract as of December 26, 20X4 because the contract, signed by ABC and sent to Customer, constituted an offer that Customer accepted by executing the purchase order, even if it did not execute the agreement until a few days later.

There is a contract between the parties under Topic 606 as of December 26, 20X4. Consequently, assuming that this is a single element arrangement or that the 100 user licenses to Product A are distinct from any services (e.g. PCS or professional services) in the contract, ABC would recognize revenue for the transfer of the 100 user licenses on December 30, 20X4.

By way of comparison, under legacy US GAAP, ABC would not have had persuasive evidence of an arrangement because ABC has a standard business practice of using signed written contracts. Because the contract was not signed by both parties until January 2, 20X5, revenue related to the delivery of the 100 user licenses could not have been recognized any earlier than that date.

Question B30
If a Master Service Agreement (MSA) exists between an entity and a customer under which the customer requests goods and services through purchase orders is the MSA a contract under Topic 606?

Interpretive response: It depends, and this is illustrated in Example B20.1. If the MSA merely defines the terms and conditions under which the customer can order goods and services from the entity, but does not create enforceable rights and obligations on the parties (i.e. for the entity to transfer goods or services and for the customer to pay for those goods or services), there is not a contract between the parties until the customer places a purchase order (PO) under the MSA.

Some entities enter into MSAs with customers, which specify the basic terms and conditions for subsequent transactions between the parties and are signed by both the entity and customer. Under such arrangements, no additional contractual agreement is executed and customers request products through POs that specify the products and quantities. An MSA under which a customer places POs in order to obtain goods or services does not itself constitute a contract with a customer. This is because the MSA usually does not create enforceable rights and obligations for the parties. As discussed in Question B20, in order for a contract to be enforceable an entity should be able to identify each party's rights regarding the goods and services to be transferred. While the MSA may specify the payment terms for goods or services to be transferred, it usually does not specify the goods (e.g. licenses) and services, including quantities thereof, to be transferred. Absent those specific terms and conditions, a contract within the revenue model of Topic 606 does not exist (i.e. the contract will not meet the criteria in paragraph 606-10-25-1).

However, some MSAs may include a requirement for the customer to purchase a minimum quantity of goods or services from the entity. This may be a cumulative minimum for the MSA period or for periods within the MSA (e.g. each year of a multi-year MSA). If the minimum is enforceable, then the MSA itself may constitute a contract under Topic 606. However, if the entity's past practice of not enforcing MSA minimums results in a conclusion that the minimums are not legally enforceable, the MSA would not be a contract under Topic 606 (i.e. just as if the minimum were not included in the MSA at all). In addition, if relevant experience with the customer suggests that the customer will not meet the required minimums, and that the entity will not enforce them, this would typically demonstrate the entity and the customer are not committed to the minimums in the contract as per paragraph 606-10-25-1(a). Consequently, even if the entity's past practice of not enforcing MSA minimums doesn't result in a conclusion that the minimums are not legally enforceable, the contract may still not meet all of the criteria in paragraph 606-10-25-1. It would therefore not be a contract within the revenue model of Topic 606.

When an MSA does not create enforceable rights and obligations with respect to transferring goods or services on its own, it will normally be the combination of a PO with the MSA that does so. Therefore the MSA and the PO would be evaluated together to determine whether the Step 1 criteria are met and a contract exists. However, if additional steps must be taken for the PO to create legally enforceable rights and obligations (e.g. executing a supplemental contract or addendum to the MSA subsequent to receipt of the PO), then a contract with a customer does not exist until those steps are completed. Other examples of additional steps may include acceptance of the PO and/or issuance of a sales order acknowledgment form by the entity to the customer. In some cases, the customer may have to accept the invoice issued by the entity in order for payment of consideration to be legally enforceable.

If either party can cancel a PO entered into under an MSA without penalty before the entity transferring the ordered goods or services (e.g. before transferring a software license), a contract does not exist, even if all the conditions in paragraph 606-10-25-1 are met. In this situation, a contract is not deemed to exist because each party has a right to terminate the contract and the contract is wholly unperformed (the entity has not transferred any 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 the promised goods or services) in accordance with paragraph 606-10-25-4. However, in contrast, if the entity transfers some or all of the goods or services in the PO, the contract would no longer be wholly unperformed. The entity would at least be entitled to receive consideration in exchange for the goods or services transferred to the customer.

Example B30.1
Prepaid spending account

ABC Corp. enters into an arrangement with Customer whereby Customer agrees to spend $2 million with ABC over a two-year period. Customer prepays the $2 million at the date the prepaid spending account (PSA) is agreed to and then 'draws down' from that balance over the two-year period by issuing purchase orders (POs) for specific software licenses and services (which may also require additional Statements of Work (SOWs) depending on the nature of the service) against a mutually agreed price list. The price list includes most of ABC's software licenses and services. The PSA agreement establishes the prepaid amount, the two-year term, and the price list that includes all of the other relevant terms and conditions under which draw-downs (through POs) will be made (e.g. warranties, delivery mechanisms and scope of rights granted for the various software licenses). The $2 million upfront payment is subject to a 'use it or lose it' provision – that is, any amounts Customer does not use through draw-downs by the end of the two-year PSA term is forfeited and none of the $2 million is refundable to Customer.

The price list in the PSA permits Customer to select from a wide variety and quantity of ABC's software licenses and services. For many of the services, an additional SOW would be necessary to establish the parameters of the services to be provided, the PSA merely sets out the hourly rate that will be applied to services of that nature. Consequently, even though the PSA sets out many terms and conditions, and establishes, in effect, a minimum quantity of ABC's software and services that Customer will acquire, until Customer executes a PO (and potentially also an SOW in the case of most professional services offerings on the price list), ABC cannot identify each party's rights regarding the licenses or services to be transferred because the entity does not know what software licenses or services it will be required to transfer. ABC also has no obligation to transfer any licenses or services until Customer executes a PO making its selections.

Only at the point in time that Customer executes a PO (and potentially also an SOW) under the PSA does ABC have a present obligation to transfer licenses and/or services to Customer and can ABC identify each party's rights regarding specific licenses and services it will transfer to Customer. Consequently, the contract between ABC and Customer under Topic 606 is the combination of the PSA and the PO (or PO/SOW if the PO includes services that require an SOW). Each PO will be a separate contract unless it is combined with another PO based on the contract combinations guidance in Topic paragraph 606-10-25-9.

Comparison to legacy US GAAP

Under legacy US GAAP, an MSA did not provide 'persuasive evidence of an arrangement' if the entity's customary business practice was to obtain a purchase order (PO) from its customers to specify the products/services and quantities. If so, the persuasive evidence of an arrangement criterion would only be satisfied upon receipt of the customer's PO. However, if the entity intends to execute a supplemental contract or addendum to the MSA subsequent to receipt of a PO, revenue may not be recognized until both the entity and the customer execute that additional agreement.

The guidance in Topic 606 is similar from the perspective that an MSA may not create enforceable rights and obligations on an entity and its customer. However, under Topic 606, the question is about whether enforceable rights and obligations exist without the PO, rather than on whether the *form* of the contract without the PO is consistent with the entity's customary business practices. Because of this, entities may, in some circumstances, reach different conclusions about the effect of having a PO on whether a contract exists under Topic 606 than they would have reached about whether a PO was necessary to having persuasive evidence of an arrangement.

Question B40

Does the form of an entity's contracts and evidence of approval have to be consistent across customers?

Interpretive response: No. An entity may have a customary business practice of using written contracts or purchase orders to evidence an arrangement. However, the entity may enter into arrangements with certain customers whose business practices of providing evidence of an arrangement differ from the entity's customary practice of using written contracts (i.e. certain customers may license software products only by purchase orders). In fact, the entity may not have a customary business practice if it principally relies on whatever method its customers prefer. For example, an entity may not have a customary business practice of using written contracts or purchase orders but certain of the entity's customers may require signed written contracts or the issuance of written purchase orders to purchase goods or services.

Because, under Topic 606, the form of the contract does not, in and of itself, determine whether a contract exists (see the discussion on enforceable rights and obligations in the overview to this chapter, as well as the discussion in Questions B10–B30); whether the entity is consistent in the form of its contracts and/or its evidence of approval of those contracts also do not, in isolation, affect whether a contract exists.

Example B40.1

Form of the contract and approval does not affect contract conclusion

ABC Corp. is a provider of computer security software. ABC provides time-based licenses to its customers. ABC has a customary business practice of executing formal license agreements with its customers, including amendments for license renewals.

Customer has licensed ABC's software for the last two years and its current term license will expire on December 31, 20X0, which is also ABC's fiscal year-end. On December 30, 20X0, ABC and Customer (i.e. an authorized officer of Customer) correspond via email in which Customer requests to renew its license for an additional two years and ABC quotes Customer a fee of $200,000 for the renewal. The email offer from ABC includes all of the substantive terms and conditions normally included in ABC's renewal amendments. Customer responds via email accepting the offer later on December 30, 20X0, and on December 31, 20X0, Customer emails ABC a purchase order for the two-year renewal license at the agreed-upon fee. For various reasons, a written renewal amendment to the parties' master license agreement is not executed or signed by both parties until January 8, 20X1.

A contract may exist as of ABC's December 31 fiscal year-end. Unlike under legacy US GAAP, the absence of an executed, written renewal amendment does not, in isolation, preclude a contract from existing before that amendment being formally executed.

Depending on various facts and circumstances (e.g. the governing jurisdiction), either the email accepting ABC's offer (which occurred on December 30, 20X0) or the written purchase order (issued on December 31, 20X0) may create enforceable rights and obligations on the parties as well as permit ABC to conclude that the contract existence criteria in paragraph 606-10-25-1 have been met before executing the formal written amendment.

ABC's evaluation of whether enforceable rights and obligations exist would typically include an assessment of its customary business practices and past experience with what has been enforced in the jurisdiction governing this contract. Meanwhile, the substance of the email communications (which, in this case, included all of the substantive terms and conditions normally included in ABC's renewal amendments) and the written purchase order would affect whether the criteria in paragraph 606-10-25-1 are met (e.g. whether the entity can identify each party's rights regarding the goods or services to be transferred and/or the payment terms for the goods or services to be transferred).

Note that even if a contract exists as of ABC's fiscal year-end, ABC will not necessarily recognize revenue from the license renewal during its current fiscal year. ABC will need to consider the guidance in paragraphs 606-10-55-58B through 55-58C in order to make that determination (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*).

Question B50

Are 'side agreements' contracts under Topic 606?

Side agreements

Software entities may enter into side agreements with customers outside of the normal contracting process (e.g. as part of the negotiation process or in response to an actual or perceived customer service issue). Those entities' sales and marketing staff may be motivated to make commitments to customers (verbally, written or electronically transmitted – e.g. email) that are not part of the master arrangement with the customer (often referred to as side agreements or side deals) in order to consummate a sale.

Interpretive response: All terms and conditions that create enforceable rights and obligations need to be considered in evaluating a contract, regardless of whether the form of some of those terms and conditions (e.g. in an email or letter agreement, which may be considered a 'side agreement') differs from other terms and conditions in the contract (e.g. those included in a formal 'master agreement' or 'statement of work'). The form in which additional terms and conditions are agreed generally will not affect whether those terms and conditions are part of the contract under Topic 606. This is because Topic 606 does not focus on the form of the contract or its approval, but rather on whether enforceable rights and obligations on the parties are specified and the parties are committed to meeting their respective obligations.

However, an entity should assess whether the form used to communicate certain terms and conditions being different from that of the master agreement (or associated agreements) affects whether the terms and conditions have been established or change the enforceable rights and obligations to which the parties are committed. 'Side agreements' often occur outside the entity's standard contract procedures. Those contract procedures may have been established by an entity to ensure enforceability of contracts entered into with its customers.

A particular side agreement may not, in and of itself, create enforceable rights and obligations on the parties. However, in accordance with paragraphs 606-10-25-16 and 606-10-32-7, respectively, the side agreement may create a reasonable expectation on the part of the customer that a promised good or service will be transferred; a valid expectation that a discount, rebate or some other form of price concession (including extended payment terms) will be granted; or even that the terms of the written contract will not be enforced. A *pattern* by the entity of providing free or discounted good or services, or providing subsequent discounts, rebates or extended payments, as a result of side agreements that are not legally enforceable contracts may create implied performance obligations, variable consideration and/or significant financing components that the entity will need to account for in future contracts if they create a reasonable expectation on the part of those customers that they will receive those items or price concessions.

Comparison to legacy US GAAP

Under legacy US GAAP, side agreements were particularly troublesome in software licensing arrangements because of the requirement to have vendor-specific objective evidence of fair value (VSOE) for each undelivered item in order to account for delivered items separately from the undelivered items – that is, in order to recognize revenue for delivered items. If there were undelivered items for which VSOE was not established, all of the revenue under the related contract would be deferred, including for delivered items, until VSOE was established for all remaining undelivered items or until the last item was delivered (unless the only undelivered item was PCS or hosting services in which case the total consideration would be recognized ratably over that service period).

Side agreements were also troublesome because of the relatively punitive guidance that applied to entities with a history of granting concessions to customers. A history of granting concessions to customers would call into question whether the fees in the entity's arrangements were fixed or determinable. Revenue under arrangements for these entities was often significantly deferred, even beyond the point at which cash was received, and was recognized only once the arrangement consideration was deemed to be fixed (i.e. the risk of concession had abated).

Topic 606 eliminates the VSOE requirement that previously applied to software licensing arrangements and substantially changes the effect on a software entity's revenue recognition of a pattern of concessions (see Questions C90 and D130). Therefore, the accounting consequences of many side agreements (e.g. those that grant price or additional good/service concessions) may not be as significant as under legacy US GAAP. That is, these types of side agreements may result in the deferral of *some* of the contract consideration – for example, for additional, undelivered goods or services or for potential discounts or rebates – but will typically not result in the deferral of all contract consideration as frequently occurred under legacy US GAAP due to the VSOE requirement and the restrictive guidance on concessions.

However, other types of side agreements may still result in an entity not recognizing any revenue from a contract even as it transfers goods (including licenses) or services. For example, a side agreement that negates the customer's obligation to pay for good or services would generally prohibit the entity from recognizing any revenue until either one of the events in paragraph 606-10-32-7 are met or until the entity's enforceable rights to consideration are re-established (e.g. through a modification to the side agreement). Similarly, a side agreement that promises unspecified future concessions may result in a conclusion that the entity cannot identify each party's rights and obligations in the contract, which is a requirement for a contract to exist in accordance with paragraph 606-10-25-1.

Question B60

Does a contract exist for services such as PCS or SaaS when an entity continues to provide the services after the expiration of the contract with the customer?

Interpretive response: Entities may continue to provide services to a customer (e.g. PCS, hosting services, or SaaS) after the expiration of the contract. Whether a contract exists in those circumstances depends on whether enforceable rights and obligations exist after the expiration of the previous contract.

Determining whether an enforceable contract exists

Even if there are no provisions in the contract to continue the services after expiration of the contract and the entity continues to provide the services under the terms of the expired contract while a new contractual arrangement is being negotiated, enforceable rights and obligations may still exist and there may be evidence that both parties are committed to those obligations.

There may be circumstances in which an entity could conclude that there are legally enforceable rights and obligations even in the absence of a formal renewal agreement. Judgment may be required to support that both parties are committed to their respective obligations after the expiration of the written agreement. Additional evidence might include consideration by the entity of its past practice of invoicing for the continuation of services subsequent to an expired agreement and whether its customers, including the present customer if this situation has previously arisen, have continued to pay (and the enforceability of those amounts had they not).The entity's provision of the services and the customer's continued payment of the service fees may provide evidence to demonstrate such commitment. Additionally, an entity might consider in its evaluation any received customer purchase orders, whether contract negotiations have begun and/or any email communications evidencing the customer's intent to continue the services and pay for such services. An entity might also consider its history with the customer, and potentially other similar customers, in terms of whether the customer has previously continued services after contract expiration and paid for such services or entered into a contract extension that addressed those services. Ultimately, evidence of behaviors may not be sufficient to conclude that enforceable rights and obligations exist and legal interpretation by competent counsel may be required.

Lastly, the entity would need to conclude that collectibility of amounts due for the continued services is probable.

If there is an enforceable contract within the scope of the revenue model

Revenue would continue to be recognized as the services are provided based on the terms and conditions of the contract. If the fees for the services are uncertain because of ongoing negotiations to enter into a formal agreement, the entity would be required to estimate the total amount of variable consideration (subject to the constraint) to which it would be entitled in exchange for providing the services (for further discussion of variable consideration and the constraint, see *Chapter D – Step 3: Determine the transaction price*). When the formal agreement is executed, if the fees for the services provided post-expiration are changed (e.g. the parties agree on a monthly service fee of $100, while the entity had been invoicing, and the customer paying, $105), this would either result in an adjustment to the variable consideration included in the transaction price by the entity or, if the consideration was not deemed to be variable (e.g. because the entity had no indication that the formal contract would not codify the monthly services fees it was charging the customer), as a contract modification (see *Chapter G – Contract modifications*).

If there is not an enforceable contract within the scope of the revenue model

The entity would first consider the guidance for consideration received before concluding a contract exists (paragraph 606-10-25-7) to determine if revenue can be recognized. We believe the conclusion about whether revenue can be recognized based on that guidance could differ depending on whether the guidance applies:

a. because enforceable rights and obligations do not exist (i.e. a legally binding contract does not exist); or
b. solely because the collectibility criterion is not met.

If there is not a contract within the revenue model because a legally binding contract does not exist ((a) above), we do not believe any of the criteria (a-c) in paragraph 606-10-25-7 can be met. That is, in the absence of a legally binding contract, we do not believe it is possible for the entity to conclude that it has (1) no remaining obligations to transfer goods or services, (2) received all, or substantially all, of the consideration promised (the entity does not have an enforceable promise from the customer to pay any amount of consideration) or (3) received consideration that is nonrefundable. Item (1) must be met to meet criteria (a) or (c). Meanwhile, item (2) must be met to meet criterion (a) and item (3) must be met to meet any of the criteria in paragraph 606-10-25-7.

Excerpt from ASC 606-10

> Identifying the Contract

25-7 When a contract with a customer does not meet the criteria in paragraph 606-10-25-1 and an entity receives consideration from the customer, the entity shall recognize the consideration received as **revenue** only when one or more of the following events have occurred:

a. 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.
b. The contract has been terminated, and the consideration received from the customer is nonrefundable.
c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

In contrast, if a legally binding contract exists, but the contract is not within the scope of the revenue model such that the guidance in paragraph 606-10-25-7 applies solely because the collectibility criterion is not met (b. above), the entity may be able to conclude on each of the items (1) – (3) outlined in the preceding paragraph.

For example, if the legally binding contract does not obligate the entity to provide services beyond either those it has already performed or those for which the customer has already paid (e.g. the current month's services paid in advance), the entity would likely be able to recognize revenue for the services it has already provided and for which it has received substantially all of the consideration to which it is legally entitled. That is, in accordance with paragraph 606-10-25-7(a), the entity might be able to conclude that it has no remaining obligation to provide further services (i.e. beyond those already provided after the previous contract expired) and has received substantially all of the consideration to which it is entitled for those services such that it can recognize revenue for the services once those services are complete and substantially all of the consideration to which it is entitled for those services has been received.

Regardless of the reason for concluding that there is not an enforceable contract within the scope of the revenue model, if none of the criteria in paragraph 606-10-25-7 are met, the entity would defer any consideration received from the customer and recognize it as a deposit liability until there is an enforceable contract within the scope of the revenue model. At that point in time, the entity would recognize revenue on a cumulative catch-up basis for the services already provided under the newly established contract and account for the remainder of the contract in the same manner as any other services contract within the scope of Topic 606.

Example B60.1
Contract continuation for PCS

ABC and Customer have a longstanding relationship. The parties' latest 12-month PCS agreement expired on May 31, 20X3 and did not include any provision for automatic renewal of the PCS. Customer paid $12,000 upfront for the 12 months of PCS on June 1, 20X2, which was the observable stand-alone selling price for the PCS.

A new PCS agreement requiring a fee of $10,800 for the 12-month period of June 1, 20X3 to May 31, 20X4 is signed on July 31, 20X3. No agreement existed from June 1, 20X3 until July 31, 20X3, although ABC continued to provide PCS in anticipation of executing an agreement for the 12-month period following the expiration of the prior agreement. As per its customary business practice, ABC invoiced Customer for the June 1, 20X3 through May 31, 20X4 PCS in May 20X3 at the amount that was agreed for the preceding year (i.e. $12,000). ABC concludes, based on advice of legal counsel, that an enforceable contract did not exist between June 1, 20X3 and July 31, 20X3.

ABC recognizes its PCS revenue over time using a time-based measure of progress (see Question F220).

Scenario 1: Customer does not pay initial invoice

Customer did not pay ABC's $12,000 invoice issued in May 20X3. ABC canceled that invoice on July 31, 20X3 when the new contract was executed, and issued a new invoice for the agreed-upon $10,800, which Customer paid timely.

On July 31, 20X3 ABC recognizes PCS revenue of $1,800, which is equal to two months of PCS at an annual rate of $10,800, on a cumulative catch-up basis, that ABC has already provided under the newly established contract. ABC also recognizes a receivable of $10,800 (Customer pays the $10,800 timely thereafter) and a contract liability (deferred revenue) of $9,000. ABC will recognize $900 in PCS revenue per month for the remaining 10 months.

Scenario 2: Customer partially pays the initial invoice

Customer partially paid ($4,000) the $12,000 invoice issued by ABC in May 20X3. When the new contract was concluded on July 31, 20X3, Customer paid ABC the balance of the $10,800 new contract PCS fee ($10,800 – $4,000 = $6,800).

Despite the fact that Customer partially paid the $12,000 invoice, ABC does not recognize any revenue until the new agreement is established on July 31, 20X3. Notwithstanding the fact that services have been provided and cash received from Customer, ABC is unable to conclude that any of the criteria in paragraph 606-10-25-7 are met before the new agreement is entered into. Therefore, ABC records the $4,000 received from Customer as a deposit liability. On July 31, 20X3, ABC recognizes $1,800 in PCS revenue consistent with Scenario 1. However, because of the $4,000 prepayment by Customer, at July 31, 20X3, ABC only has a receivable of $6,800 (versus $10,800 in Scenario 1), and has a contract liability of $9,000.

Scenario 3: Customer partially pays, and entity has history of enforcing payment

Assume the same facts as in Scenario 2 except that ABC concludes an enforceable contract *does* exist based on relevant experience with enforcing similar arrangements and the advice of legal counsel.

Because an enforceable contract exists on June 1, 20X3, ABC continues to recognize PCS revenue as it provides the PCS to Customer, only at an amount other than the $1,000 per month it had been recognizing under the previous PCS contract. Because the transaction price for the PCS it is providing subsequent to expiration of the prior agreement is uncertain – i.e. ABC knows from relevant experience that Customer will likely negotiate a lower PCS fee than the $12,000 in the prior year – ABC is required to estimate the consideration to which it will be entitled (subject to the constraint on variable consideration) for providing the PCS during the post-expiration period and recognize revenue based on that estimate. *Chapter D – Step 3: Determine the transaction price* discusses estimating variable consideration, subject to the constraint, in further detail.

When the new agreement is signed on July 31, 20X3 (assuming, in this scenario, that ABC is unable to resolve the uncertainty associated with the new agreement's transaction price before execution of the new agreement), ABC will true-up the revenue recognized for the post-expiration period based on resolution of the uncertainty surrounding the transaction price for the PCS provided during those periods. For example, if ABC estimated, subject to the constraint, that it would be entitled to $700 for each of the two post-expiration months of PCS, on July 31 when the new agreement is signed with a transaction price for the full year of $10,800 (which equates to $900 per month for the year June 1, 20X3 through May 31, 20X4), ABC would recognize a cumulative catch-up revenue adjustment of $400 ($1,800 – $1,400).

Comparison to legacy US GAAP

While in some of the scenarios addressed by Question B60 an entity may conclude that an enforceable contract exists, under legacy US GAAP, it was generally not the case that an entity could conclude that persuasive evidence of an arrangement existed after expiration of the contract period if its customary business practice was to obtain a signed contract for the extension or renewal period.

Cumulative catch-up vs prospective

Under legacy US GAAP, no revenue was recognized in post-expiration service periods if persuasive evidence of an arrangement did not exist and/or the fees for the services were not fixed or determinable. Once persuasive evidence of an arrangement had been obtained, and the fees were fixed or determinable, the PCS fees were recognized prospectively, on a ratable basis, over the remainder of the new PCS contract term (other than in some scenarios, such as the reinstatement of PCS, where additional deliverables – e.g. specified updates or upgrades – had been transferred to the customer during the lapse in agreement period). For example, in Scenario 1 of Example B60.1, ABC would have recognized the $10,800 PCS fees in the agreement executed on July 31, 20X3 ratably over the period from August 1, 20X3 through May 31, 20X4 ($1,080 per month).

Recognizing revenue on a cumulative catch-up basis, as described in Question B60 and illustrated in Example B60.1 (in Scenario 1 and Scenario 2), is a significant change from legacy US GAAP.

Question B70

Does a fiscal funding clause affect whether a contract exists under Topic 606?

Interpretive response: It depends. Fiscal funding clauses sometimes are found in software licensing and other (e.g. SaaS) arrangements in which the customers are governmental units. Such clauses generally provide that the contract is cancellable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the contract.

A funding contingency, from a business enterprise or governmental unit, may render the agreement to not be an enforceable contract under applicable laws and/or regulations if the chance of the fiscal funding contingency being triggered is more than remote. Judgment will need to be applied in those contracts to determine whether a contract exists before funding has been approved – i.e. whether the contract existence criteria in paragraph 606-10-25-1 are met.

Even if a contract is determined to exist in an arrangement with a fiscal funding clause, a fiscal funding clause *that has a more than remote chance of being triggered* may affect the enforceable contract term. This is because, in accordance with paragraph 606-10-25-3, an entity applies the guidance in Topic 606 to the duration of the contract (i.e. the contractual period) for which the parties to the contract have *present* enforceable rights and obligations, and such rights may not presently exist beyond the existing fiscal authorization (i.e. the customer has the right to unilaterally terminate services without penalty by not approving funding). For example, an agreement may be for a stated three-year period, but if the entity's enforceable right to payment for providing the services in years 2 and 3 is contingent on the customer obtaining fiscal authorization (i.e. the customer may cancel the contract if the legislature or funding authority does not authorize the expenditure), an enforceable contract may only exist for one year. In that scenario, the contract term under Topic 606 would only be the one-year period covered by the current funding commitment and any period beyond that would be considered cancellable by the customer.

An alternative view exists that we believe is also acceptable when the customer is a governmental unit and a contract otherwise exists in accordance with paragraph 606-10-25-1. Under that view, the unfunded portion of the contract, even if the chance of the fiscal funding contingency being triggered is more than remote, should be considered variable consideration; the software entity includes variable consideration in the transaction price subject to the constraint (see *Chapter D – Step 3: Determine the transaction price*).

Whichever view an entity ascribes to we would expect it to be applied consistently to similar arrangements.

Comparison to legacy US GAAP

Under legacy US GAAP, the existence of a fiscal funding clause in a software arrangement with a governmental unit necessitated an assessment of the likelihood of cancellation through exercise of the fiscal funding clause.

If the likelihood of exercise of the fiscal funding clause with a governmental unit was assessed as being remote (i.e. the chance of the future event or events occurring is slight), the software arrangement would be considered non-cancellable and, thus, revenue would be recognized if the other revenue recognition criteria were met. If the likelihood of exercise was assessed as other than remote, the license was considered cancellable, thus precluding revenue recognition until the funding was authorized or the contingency became remote.

A fiscal funding clause with a customer other than a governmental unit created a contingency that precluded revenue recognition until the requirements of the clause were met.

For software entities that ascribe to the first view outlined in the question, we do not expect that the effect of a fiscal funding clause will be substantially different under Topic 606 than it was under legacy US GAAP. However, the variable consideration approach to the unfunded portion of the contract will be a significant change in how fiscal funding clauses are considered for those entities that apply that alternative to governmental contracts.

Collectibility

Question B80

What factors should an entity consider in determining whether the amount of consideration to which an entity expects to be entitled includes an implicit price concession?

Interpretive response: The collectibility criterion is applied to the amount to which the entity expects to be entitled in exchange for the goods and services that 'will be transferred to the customer'. That amount may not be the stated contract price for those goods or services that will be transferred to the customer. The amount of consideration to which the entity expects to be entitled considers whether the promised consideration is variable (i.e. is different from the stated contract price) due to facts and circumstances that, at contract inception, indicate the entity may offer a price concession to the customer. It may be difficult to distinguish between situations in which there is a significant risk the customer will not pay the promised consideration for the goods and services that will be transferred to the customer (i.e. a collectibility issue) and situations in which the entity will *accept* an amount of consideration that is less than the promised amount in return for those goods and services (i.e. an implicit price concession).

Topic 606, including the two examples of implicit price concessions (Examples 2 and 3 in paragraphs 606-10-55-99 through 55-105), does not provide any explicit guidance about how to determine if an entity may grant an implicit price concession. However, the Basis for Conclusions to ASU 2014-09 (BC192) states that an entity's customary business practices, published policies or specific statements may provide evidence and/or create a valid expectation on the part of the customer that the entity is willing to accept a lower price in exchange for the promised goods and services. BC192 also indicates that price concessions may be more likely to be granted in situations where doing so would enhance a customer relationship or encourage future sales.

The Boards decided against providing further guidance on implicit price concessions. However, the FASB and IASB staffs *proposed* some additional factors that would, to varying degrees (i.e. in some cases, the factors may merely contribute to a price concession conclusion rather than provide determinative evidence in that respect), indicate that, at the time of entering into a contract, an entity intends to offer a price concession if there is a significant risk that the customer will not pay the promised consideration for the goods and services that will be transferred. While these factors are not authoritative because they were not included in Topic 606, we believe they may be useful for software entities to consider in the absence of authoritative guidance. These factors along with our view on how those factors might relate to software entities are as follows.

a. The goods or services promised to the customer are not expected to expose the entity to a significant economic loss if the customer does not pay the promised consideration. For example, an entity would not be expected to incur a significant economic loss in any of the following circumstances:

   i. The incremental costs that an entity incurs to produce the good or service or transfer it to the customer would be negligible – *This circumstance may frequently arise in software licensing arrangements because the incremental costs to transfer a software license are typically negligible. It may also frequently be the case that the incremental costs of providing PCS services or SaaS to a customer in a multi-tenant SaaS environment are minor.*

   ii. The entity can deny the customer further access to the promised good or service if the customer fails to meet its obligations under the contract – *This is typically the case in SaaS arrangements, but may also be the case in some software licensing arrangements if the entity only provides temporary software keys or has the ability to send out a 'kill' code if the customer does not pay the license fees.*

   iii. The good that transfers to the customer is not expected to depreciate substantially (or diminish in value) and, therefore, the good provides the entity with sufficient collateral in the event of the customer failing to meet its obligations under the contract. For example, the good is a tangible asset that is not expected to have depreciated substantially if and when the entity obtains control of the good from the customer – *This circumstance would not typically be the case in software or SaaS arrangements.*

b. The entity has previously chosen not to enforce its rights to the promised consideration in similar contracts with the customer (or class of customer) under similar circumstances – *Evidence that the entity has previously accepted consideration less than the promised amount in similar contracts may call into question whether the entity will accept consideration less than the promised amount in this contract*.

c. *The entity has experience* (or other evidence) about the customer not fulfilling its obligations to pay the promised consideration in other contracts – *If the entity has history of the customer not paying some or all of the promised consideration in prior contracts, the entity's willingness to enter into new contracts with the customer despite that history may suggest it will accept a partial payment as complete performance by the customer.*

d. The entity has experience (or other evidence) about the class of customer to which the customer belongs not fulfilling their obligations to pay the promised consideration in similar contracts under similar circumstances –

Similar to c. the entity's willingness to enter into a contract with a customer in a 'suspect' class – i.e. a class of customer where there is a significant credit risk – may suggest the entity will accept a partial payment as complete performance by the customer.

Variable consideration and price concessions are discussed in *Chapter D – Step 3: Determine the transaction price.*

Example B80.1

Collectibility threshold assessed based on amount the entity expects to receive for the goods or services transferred

ABC Corp. enters into an arrangement with Customer to license 1,000 seats of Product X for two years for $1,000,000. ABC's standard payment terms for similar customers entering into similar licenses are for Customer to make two equal payments, one due at contract inception and the second due at the beginning of Year 2 of the license.

ABC has a prior history with Customer. Customer has a history with ABC of requesting a reduction in the second payment due, which ABC has frequently granted in order to incent Customer to make additional purchases, including renewals, in the future. ABC further notes that this practice is not isolated to Customer; other similar high-volume customers have made similar requests that ABC has granted.

Based on all relevant facts and circumstances, ABC assesses that it is likely to accept an amount of consideration that is less than the $1,000,000 promised amount. In this contract, after consideration of the guidance on variable consideration in paragraphs 606-10-32-5 through 32-13 (see further discussion of this in *Chapter D – Step 3: Determine the transaction price*), ABC concludes that the amount of consideration to which it expects to be entitled is $900,000.

Accordingly, when assessing whether collectibility is probable, ABC assesses whether it is probable that it will receive $900,000 – i.e. the amount to which it expects to be entitled after the expected price concession.

See also Example B100.1, Scenario 2.

Comparison to legacy US GAAP

Under legacy US GAAP for software entities, collectibility was assessed against the fixed or determinable fees in the arrangement in their entirety – i.e. there was no concept of considering whether collectibility was probable only for a portion of the fixed or determinable fees.

In contrast, collectibility under Topic 606 may be assessed against an amount that is less than that promised in the contract either (1) because of an implied price concession or (2) because the goods or services that 'will be transferred to the customer' (see Questions B90 and B110) differ from the promised goods or services in the contract.

Question B85

How is 'substantially all' defined for the collectibility assessment?

Interpretive response: 'Substantially all' is not defined in Topic 606. In ASU 2016-12, the FASB amended the collectibility criterion so that it is met if 'substantially all' of the consideration to which the entity will be entitled is collectible rather than 'all' of the consideration. The FASB decided that a contract could represent a substantive transaction even if it is not probable the entity will collect 100% of the consideration to which it expects to be entitled. [ASU 2016-12.BC12]

The term 'substantially all' is used in other places in US GAAP – e.g. Topic 840 or 842 (leases) – and generally understood to mean approximately 90%. For example, Topic 842 provides guidance that 90% might be appropriate for evaluating 'substantially all'. We believe 90% should *not* be viewed as a safe harbor or bright-line and entities should consider all relevant facts and circumstances about the customer and the transaction. [842-10-55-2]

Question B90

In assessing collectibility, an entity considers only the likelihood of payment for goods or services that 'will be transferred to the customer'. What does this mean in the context of typical software related service arrangements (e.g. SaaS arrangements or PCS services sold separately from a software license)?

Interpretive response: Topic 606 provides that when an entity has *the ability* – i.e. both the right and the capability – and *the intent* (typically, evidenced by its customary business practices) to stop providing services in the event of customer non-payment, the entity does not have credit risk with respect to those services it would not be required to provide. It is for this reason that Topic 606 requires an entity to consider only the collectibility of the promised consideration in the contract (i.e. its exposure to credit risk) for the goods or services that the entity will transfer to the customer *before* it would be able to stop providing further goods or services in the event of customer non-payment. Example 1, Cases B through D, in Topic 606 demonstrate application of this concept to service contracts.

In Cases B and C, even though the contract includes a promise by the entity to provide three years of services, for which the customer pays monthly fees in arrears, the entity has the ability and intent to stop providing the promised services in the event of customer non-payment. Therefore, the services that 'will be transferred to the customer' include only those services that the entity will provide before it follows its customary business practice to stop services to the customer. While not specifically illustrated in either Case, this might mean the services that 'will be transferred to the customer' are only one or two months' of service or some longer period, depending on the entity's customary business practice with respect to how long it permits a non-paying customer to continue receiving services.

In Case D, the illustrated scenario is a one-year gym membership, but the contract requires *advance* payment each month by the customer and services (i.e. access to the gym) are not provided for any given month if the advance payment has not been received. Consequently, in Case D, the services that will be provided to the customer are only the one month of services for which the customer has prepaid.

There may be circumstances where the entity does not have either the ability to stop providing services to the customer or the demonstrated intent to do so, in which case the collectibility criterion is assessed against the promised consideration for all of the promised services in the contract. For example, an entity:

— may not have *the right* to stop providing promised services in the event of customer bankruptcy because bankruptcy rules in some jurisdictions require service providers to continue providing services that are essential to the customer while it undergoes restructuring;

— may not be *able* to discontinue a service, such as a transportation service because the transportation asset (e.g. a ship) cannot for practical reasons dump the cargo into the sea and the ship is needed at the port of call in any event in order to fulfill the entity's next contract; or

— may have demonstrated its intent *not* to discontinue services in a timely manner in the event of customer non-payment. Particularly if the incremental costs of providing services to the customer are minor, an entity may continue providing services and merely intend to pursue collection at a later point. A circumstance of this nature however may strongly indicate a likely price concession (see Question B80).

When an entity does conclude that it has the ability and the intent to discontinue services in the event of customer non-payment, how long the entity's customary business practices (or other evidence of the entity's intent) indicate that the entity will continue to provide services to a non-paying customer may influence whether the collectibility criterion is met for that contract (see Question B100).

Collectibility will generally not be a concern in service arrangements that are prepaid. For example, if the customer is required to prepay for all of the *promised* services in the contract (e.g. prepay for a three-year SaaS arrangement), then the 'will be transferred' notion will not apply.

Comparison to legacy US GAAP

Under legacy US GAAP, collectibility was assessed against the entire fixed or determinable fees in the contract. When collectibility of the arrangement was not reasonably assured, revenue was generally recognized on a cash basis when the other recognition criteria had been met.

There is no mechanism whereby an entity concludes collectibility is probable (or reasonably assured for non-software licensing arrangements, such as SaaS arrangements) based on a partial assessment of the fixed or determinable fees, such as occurs under Topic 606 when the entity concludes there is a likely price concession (see Question B80) or that the goods or services that 'will be transferred to the customer' are not the promised goods or services in the contract. As a result, entities may more frequently pass the collectibility threshold in Topic 606 than they did the collectibility threshold under legacy US GAAP.

Further, as discussed in Question B125, under Topic 606 cash basis recognition is not the default accounting when collectibility is not probable but an entity has transferred control of the related good or service.

Question B100

Does an entity's ability and intent to stop providing goods or services automatically mean that the collectibility criterion will be met?

Interpretive response: No. The collectibility criterion is met only when it is probable that the entity will collect *substantially all* of the consideration to which it will be entitled in exchange for *the goods or services that will be transferred to the customer*. If (1) it is not probable the entity will collect *any* consideration from the customer or (2) the entity does not have the ability or the demonstrated intent to discontinue services in a timely manner after the customer stops paying for the entity's services, the entity may not be able to conclude that it is probable it will collect *substantially all* of the consideration to which it is entitled for the goods or services it will provide. Consider the following examples:

- Consistent with Example 1, Case C of Topic 606, if an entity has the ability and the intent to timely discontinue services but it is not probable it will collect substantially all of the promised consideration for any services it would provide before it discontinues services, the arrangement is not a genuine and substantive transaction (see paragraph 606-10-55-3A and paragraph BC12 of ASU 2016-12).
- Assume an entity concludes it is probable a customer will pay for the first 12 months of service in a 36-month contract, but that collectibility of the remainder of the fees is not probable. If the entity does not have the ability or the intent to discontinue services for a number of months (e.g. four months) after a customer stops paying for those services, the entity may conclude that it is not probable that it will collect substantially all of the

consideration to which it will be entitled for the services that will be provided to the customer. For example, assume the monthly service fee is $100 and the entity 'will' provide 16 months of service, for which the promised consideration is $1,600. However, it is only probable that the entity will collect $1,200 ($100/month × 12 months). In that case, it is not probable the entity will collect substantially all of the promised consideration for the services it 'will' provide to the customer unless the entity concludes that the $1,200 it expects to collect is also the amount to which it expects to be entitled (i.e. it expects to grant a price concession to the customer – see next paragraph).

In either of the above cases, the entity would account for the contract using the alternative model in paragraph 606-10-25-7 until either (1) one of the events in paragraphs 606-10-25-7 occur or (2) collectibility of a sufficient portion – that is, substantially all – of the promised consideration for the services that will be provided becomes probable. However, in the latter case, it may be that the entity is implicitly willing to accept an amount of consideration that is less than the promised amount (i.e. the entity will grant an implicit price concession) *even if* the entity pursues collection of all amounts owed – see Question B80 for additional discussion of implicit price concessions. If that is the case, the entity may conclude it *is* probable that it will collect the reduced amount to which it expects to be entitled ($1,200 in the preceding bullet) and that, therefore, the collectibility criterion is met.

Example B100.1

Assessment of collectibility for low credit quality new customer

ABC Corp. enters into a non-cancellable 36-month contract to provide SaaS to Customer. Customer is a new customer of low credit quality. The consideration promised in the contract is $3,600, with $100 payable in advance each month. ABC has substantive history with this class of customer, based on which ABC concludes it is *not* probable the customer will pay all of the promised consideration for the promised 36 months of SaaS. However, based on its experience with similar customers, ABC expects Customer to make the payments required under the contract for at least 10 months. If a customer stops making the required payments (i.e. is in material breach of the contract), ABC has the right to deny that customer further access to the SaaS and ABC's customary business practice is to mitigate its credit risk by doing so. In the event of customer default, ABC always pursues collection for unpaid services such that no explicit price concession by ABC is expected.

Scenario 1: Discontinuation of services at the end of the month

ABC's customary business practice is to discontinue services by the end of the month for which a customer has not paid. For example, if a customer pays in advance for May, but does not pay for June, ABC typically discontinues services by the end of June. ABC vigorously pursues collection from all its customers and typically is successful in recovering some portion of the fees for which the customer has not paid.

ABC concludes it is probable it will collect substantially all of the consideration to which it is entitled in exchange for services that will be provided to Customer. This is because ABC expects to collect all of the promised consideration in the contract for at least 10 months of service and, if Customer defaults, some portion of the fees to which it would be entitled for whatever month of service after that Customer does not pay.

Scenario 2: Discontinuation of service after 5 months

ABC's customary business practice is to discontinue services only after a customer has not paid for the service for five months. For example, if a customer pays in advance for May, but does not pay for June – October, ABC typically discontinues services by the end of October. ABC only discontinues services in this timeframe because its incremental costs to provide the services is minor and, even if it cannot recover the entire contracted fees for the unpaid months, it pursues collection vigorously and will usually recover a portion of those fees that is sufficient to cover its costs of providing the SaaS and an acceptable profit margin. That portion of the promised fees, however, is a minor portion of the promised consideration.

ABC concludes that a substantive contract exists because it will provide services to Customer for a significant period of time and expects to recover consideration that will provide a reasonable profit margin on the contract. ABC's experience with this class of customer and its history of providing services well after a customer has defaulted on its payments suggests ABC is implicitly willing to accept a lower fee than that stated in the contract with Customer. As a result, Customer concludes it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the services that will be provided to Customer. However, the transaction price includes variable consideration that ABC must estimate subject to the variable consideration constraint (see *Chapter D – Step 3: Determine the transaction price*) such that ABC will not recognize revenue of $100/month at least during the earlier part of the contract period.

Question B110

How are software licenses considered when determining the 'goods or services that will be transferred to the customer'?

Interpretive response: Software licenses are goods transferred at a point in time (see Questions F10 and F20). They are not services satisfied over the license period, even if the entity has the legal right to revoke that right of use and/or has the ability to send out a 'kill code' or similar in the event of customer non-payment.

Therefore, revoking a customer's right to use the entity's software is a repossession of the software license (i.e. repossession of a good); it is not equivalent to shutting off a service in response to a customer's failure to pay for services already provided. Paragraph 606-10-55-3C states: "An entity's ability to repossess an asset transferred to a customer should not be considered for the purpose of assessing the entity's ability to mitigate its exposure to credit risk."

Consequently, the ability to revoke a customer's right to use the entity's software in the event of non-payment of software license fees being paid over time is not considered in assessing whether collectibility of the consideration to which the entity will be entitled for the software license is probable.

If the software license is part of a combined performance obligation

In some circumstances under Topic 606, a software license will not be distinct from other goods or services and, therefore, will be part of a combined performance obligation. Example 10 (Case C), Example 11 (Case B) and Example 55 of Topic 606 illustrate examples of a license that is part of a combined performance obligation together with associated updates or services. Each of those examples illustrates that the entity determines the nature of the combined item in evaluating whether the performance obligation is satisfied over time or at a point in time and in determining the appropriate measure of progress to apply to that performance obligation if it is satisfied over time. Similarly, we believe the entity would consider the nature of the combined item that includes the license in determining whether the entity would be able to stop transferring that good or service in response to customer non-payment, and that this would mean the following for each of the three combined license and updates or services examples in Topic 606:

— **Example 10 (Case C)** – Because the combined good or service is the provision of anti-virus protection to the customer for three years (see paragraph 606-10-55-140F), if the entity has the ability and the intent to stop providing anti-virus protection – i.e. revoke the customer's right to use the anti-virus software and stop providing future updates – the 'goods or services that will be transferred to the customer' may be less than the three years of anti-virus protection promised in the contract.

— **Example 55** – Because the combined good or service is 'ongoing access' to the entity's continually changing intellectual property for three years (see paragraph 606-10-55-365A), if the entity has the ability and the intent to stop providing 'access' to its intellectual property – i.e. revoke the customer's right to use the intellectual property and stop providing future updates/upgrades – the 'goods or services that will be transferred to the customer' may be less than the three years' access promised in the contract.

— **Example 11 (Case B)** – The combined good or service is the software customization, which uses the base software and the entity's customization services as inputs to produce customized software as the output (see paragraph 606-10-55-149). If the entity has the ability and the intent to stop performing the software customization – i.e. revoke the customer's right to use the base software and stop the customization services – the 'goods or services that will be transferred to the customer' may be different from the intended combined output in the contract (i.e. the customized software).

  Note: The discussion in this bullet ignores the technical support and the software updates in the example, which are each determined to be distinct and would be considered in the same manner as any other over-time performance obligation for purposes of determining the 'goods or services that will be transferred to the customer'.

Example B110.1

Credit risk is not mitigated for a software license and PCS

ABC Corp. enters into a contract to license its software to Customer along with technical support and unspecified update, upgrade and enhancement rights (collectively, PCS) for three years. Customer is of low credit quality.

Despite Customer's credit rating, the contract fees are $100 per year, payable at the beginning of each year. Therefore, the transaction price is $300 (for ease of illustration, this example ignores any potential significant financing component that may result from paying for the software license over a three-year period). The stand-alone selling price of the software license is $180 and the stand-alone selling price of the PCS (the PCS is determined to be a single performance obligation – see Question C150) is $120 for the three-year period. Both parties are subject to termination penalties if the contract is canceled. The termination penalty is considered to be substantive.

In assessing whether the contract with Customer meets the criteria in paragraph 606-10-25-1, ABC assesses whether it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. This includes assessing ABC's history with Customer's class of customer and its business practice of stopping PCS services within a reasonable period of time in response to a customer's nonpayment in accordance with paragraph 606-10-55-3C.

At contract inception, ABC concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that Customer will pay substantially all of the consideration to which the entity will be entitled under the contract for the software license and PCS services that will be transferred to the customer. ABC concludes that not only is there a risk that the customer will not pay for the license and PCS services received from ABC, but also there is a risk that ABC will never receive *any* payment for any PCS services provided (considering the stand-alone selling price of the services is $40 per year). Subsequently, when Customer initially pays $100, ABC accounts for the consideration received as a deposit liability in accordance with paragraphs 606-10-25-7 through 25-8. ABC concludes that none of the events in paragraph 606-10-25-7 have occurred because the contract has not been terminated, the entity has not received substantially all of the consideration promised in the contract (i.e. ABC has received only $100 of $300), and ABC is continuing to provide services to Customer.

Assume that in year 2, ABC continues to conclude that the collectibility criterion has not been met. Customer's credit rating remains poor and even though $200 has now been collected, on a stand-alone selling price basis ABC has provided $220 worth of goods and services (3-year license and one year of PCS) and will provide another $40 worth of PCS before it can contractually terminate PCS if Customer does not pay the Year 3 fees of $100. Therefore, it is not yet probable Customer will pay at least substantially all of the promised consideration to which ABC is entitled for the license and PCS it will provide to Customer. Therefore, the additional $100 paid by the customer at the beginning of year 2 is, like the payment for Year 1, recorded as a deposit liability, resulting in a $200 cumulative deposit liability.

In year 3, ABC receives the remaining $100 payment from Customer B. At this point in time, none of the criteria in paragraph 606-10-25-7 have been met. However, ABC concludes that the criterion in paragraph 606-10-25-1(e) is now met because it is probable that the customer will pay substantially all of the consideration to which ABC will be entitled for the goods and services. In other words, once the final advance payment is made ($100) at the beginning of year 3, ABC concludes that it is probable that it will receive all of the consideration to which it will be entitled in exchange for the license and all three years of PCS services that are transferred to Customer.

Once the criteria in paragraph 606-10-25-1 are met in year 3, ABC applies the remaining guidance in Topic 606 to recognize revenue and the following journal entry is recorded.

	Debit	*Credit*
Deposit liability	200	
Cash	100	
License revenue		180
PCS revenue		80
Contract liability (deferred revenue)		40

Question B115

How should a software vendor assess collectibility for a portfolio of contracts?

Interpretive response: The TRG agreed that collectibility should be assessed at the individual contract level – i.e. the individual contract is the unit of account. [TRG Agenda Paper No. 13]

For example, assume that an entity has 1,000 similar contracts and historical experience indicates that the entity will not collect on 2% of these contracts. This does not mean that the collectibility criterion is not met for 2% of the contracts. Rather, the entity evaluates whether collection is probable for an individual contract based on its customary procedures performed prior to entering into the arrangement to determine the credit risk associated with the individual customer. [TRG Agenda Paper No. 13]

If this evaluation indicates that collectibility is probable, the entity accounts for the contract under Topic 606. [TRG Agenda Paper No. 13]

However, in some situations, an entity may use a portfolio of historical data to estimate the amounts that it expects to collect. This type of analysis may be appropriate when an entity has a high volume of homogeneous transactions.

These estimates are then used as an input into the overall assessment of collectibility for a specific contract.

For example, if on average a software vendor collects 60% of amounts billed for a homogeneous class of customer transactions and does not intend to offer a price concession, this may be an indicator that collection of the full contract amount for a contract with a customer in that class is not probable. Therefore, the collectibility criterion may not be met for that contract.

Conversely, if on average a software vendor collects 90% of amounts billed for a homogeneous class of contracts with customers, then this may indicate that collection of the full contract amount for a contract with a customer in that class is probable. In that case, the collectibility criterion may be met.

However, if the average collections were 90% because the software vendor generally collected only 90% from each individual contract, this may indicate that the vendor has granted a 10% price concession to its customer. For a discussion of the differentiation between collectibility and a price concession see Question B80.

Question B120

Do extended payment terms affect the evaluation of the collectibility criterion?

Interpretive response: Extended payment terms, which would include situations in which an entity pays for a distinct license through equal payments for the license and PCS over an extended period (e.g. three years), do not in and of themselves affect whether the collectibility criterion in paragraph 606-10-25-1(e) is met. However, they will likely factor into the entity's assessment of the credit risk to which it is subject as a result of the contract. That is, extended payment terms introduce credit risk as a consideration about the customer's ability or intention to pay the consideration to which the entity is entitled for the goods and services that 'will be transferred to the customer' where no such question would exist if the customer were required to pay for the goods or services as transferred or under non-extended payment terms.

As discussed further in *Chapter D – Step 3: Determine the transaction price*, extended payment terms may indicate either or both that:

— there is the risk of a future price concession, which would result in a conclusion that the transaction price is variable. In that case, the entity would need to consider whether it expects to provide a concession, and the transaction price would be subject to Topic 606's constraint on variable consideration;
— a significant financing component exists in the contract.

Comparison to legacy US GAAP

Under legacy US GAAP applicable to software licensing arrangements, extended payment terms do not affect whether persuasive evidence of an arrangement exists. Rather, the arrangement fee is presumed not to be fixed or determinable if payment of a signification portion of the license fee is not due until after expiration of the license, or more than 12 months after delivery of the licensed software. As such, revenue is generally not recognized until the payments become due and payable.

The fact that the collectibility of extended payments affects whether a contract exists for purposes of applying Topic 606 is a change from legacy US GAAP. In addition, the fact that extended payment terms may affect the *measurement* of revenue (i.e. if there is determined to be variable consideration or a significant financing component in the contract), but not the timing of revenue recognition, is a substantial change from legacy US GAAP.

Question B125

Can revenue be recognized on a cash basis when the collectibility criterion is not met and the entity continues to provide goods or services to the customer?

Interpretive response: No. If the collectibility criterion is not met, an entity continuing to provide goods or services to the customer cannot record revenue based on its collections unless the alternative model criteria in paragraph 606-10-25-7 are met (see decision tree at the beginning of this chapter). Under the alternative model, an entity cannot recognize revenue when it has a remaining obligation to transfer goods or services to a customer or it chooses to continue to transfer goods or services to a customer when substantially all of the consideration to which it is legally entitled has not been received.

There are limited scenarios in which an entity can continue to transfer goods or services under a contract, determine collectibility is not probable, but nevertheless recognize some revenue. This is because the collectibility criterion is evaluated based only on the goods or services expected to be transferred. See Questions B90 and B100 for the evaluation of arrangements where an entity has the ability and intent to stop providing the promised goods or services due to customer non-payment.

Question B126
When does an entity reassess the collectibility criterion?

Interpretive response: Once an entity determines that a contract exists under Step 1 of the revenue model (including assessing the collectibility criterion), it does not reassess the collectibility criterion unless there is a significant change in facts and circumstances that results in a significant deterioration in the customer's creditworthiness. For example, a significant deterioration in a customer's ability to pay because it lost one of its customers that accounts for 75% of its annual sales would likely lead to a reassessment. [606-10-25-5]

The determination of whether there is a significant deterioration in the customer's creditworthiness will be situation-specific and will often be a matter of judgment. The evaluation is not intended to capture:

- changes of a more minor nature that do not call into question the existence of the contract; or
- changing circumstances that might reasonably fluctuate during the contract term (especially for a long-term contract) that do not have a significant effect. [TRG Agenda Paper No. 13]

If, after a significant change in facts and circumstances, the entity determines that collectibility is no longer probable, it discontinues using the general revenue model and follows the guidance on accounting for consideration received when a contract does not exist – the alternative model in paragraph 606-10-25-7 (see Question B125). However, the entity does not reverse revenue previously recognized.

If an entity determines that a contract does not exist under Step 1 of the revenue model, it continually reassesses the arrangement. If the criteria for Step 1 are subsequently met, the entity begins applying the revenue model to the arrangement.

Example B126.1
Cash received when collectibility criterion is not met

ABC Corp. provides Customer with three years of access to its networking platform in exchange for monthly payments of $10,000. In January of Year 2 of the contract, Customer experiences a significant decline in its business and has difficulty meeting its financial commitments.

ABC agrees to extended payment terms that allow Customer to make nonrefundable payments of $2,000 per month during Year 2, with the remaining amounts due in Year 3. The contract is not terminated, ABC continues to provide Customer with access to its platform and intends to enforce payment for remaining amounts in Year 3. ABC performs a reassessment of the contract existence criteria and determines that collectibility of the remaining consideration to which it expects to be entitled is not probable.

ABC receives $15,000 in partial payments in Year 2. Because the collectibility criterion was not met upon reassessment, ABC must evaluate the alternative model criteria in paragraph 606-10-25-7 to determine how to recognize revenue for the $15,000 nonrefundable payment received.

- The first criterion is not met because Customer has not remitted substantially all of the consideration promised for the services provided.
- The second criterion is not met because the contract has not been terminated.
- The third criterion is not met because ABC has not stopped transferring services to Customer.

Based on the evaluation of the alternative model criteria, ABC cannot recognize revenue for the cash received from Customer in Year 2. Therefore, even though ABC received $15,000 in cash consideration, ABC recognizes a deposit liability for $15,000 and records no related revenue.

Note: If the contract existence criteria (including the collectibility criterion) or one of the criteria in the alternative model is met upon reassessment in Year 3, ABC would record a cumulative catch-up to revenue for the services already provided.

Question B127

Is a receivable recognized if the collectibility criterion is not met?

Interpretive response: No. When an entity concludes that a contract does not exist because the collectibility criterion is not met (or because any of the other contract existence criteria are not met), an entity does not record a receivable for consideration that it has not yet received for the goods or services it has already transferred to the customer.

This is consistent with the premise in Topic 606 that when collection is not probable the contract is not substantive and therefore the legal right to consideration is also not substantive for accounting purposes. [606-10-25-2]

Term of the contract

Question B130

What is the contract term in a period-to-period (e.g. month-to-month or year-to-year) contract that (a) may be canceled by either party or (b) may be canceled by the customer only?

Excerpt from ASU 2014-09

BC50. The Boards decided that Topic 606 should not apply to wholly unperformed contracts if each party to the contract has the unilateral enforceable right to terminate the contract without penalty. Those contracts would not affect an entity's financial position or performance until either party performs. In contrast, there could be an effect on an entity's financial position and performance if only one party could terminate a wholly unperformed contract without penalty. For instance, if only the customer could terminate the wholly unperformed contract without penalty, the entity is obliged to stand ready to perform at the discretion of the customer. Similarly, if only the entity could terminate the wholly unperformed contract without penalty, it has an enforceable right to payment from the customer if it chooses to perform.

BC391. A renewal option gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. This type of option could be described as a renewal option within a relatively short contract (for example, a one-year contract with an option to renew that contract for a further year at the end of the first and second years) or a cancellation option within a longer contract (for example, a three-year contract that allows the customer to discontinue the contract at the end of each year). A renewal option could be viewed similarly to other options to provide additional goods or services. In other words, the renewal option could be a performance obligation in the contract if it provides the customer with a material right that it otherwise could not obtain without entering into that contract.

Interpretive response: A contract under which services are provided period-to-period (e.g. month-to-month or year-to-year) unless canceled by either party, and for which no penalty must be paid for cancellation (i.e. other than paying amounts due as a result of goods or services already transferred up to the termination date), is no different from a similar contract structured to require the parties to actively elect to renew the contract each period (e.g. place a new order, sign a new contract). This is regardless of whether both entities may cancel the contract or solely the customer. Consequently, an entity does not assume a contract period that extends beyond the then-current period. This is the case regardless of whether the contract has a stated contract period (e.g. a two-year stated term, but either entity can cancel the contract at the end of any month during that period for no penalty).

When both parties to the contract have the unilateral right to terminate the contract at the end of any designated period, a contract does not exist for periods beyond the then-current period in accordance with paragraph 606-10-25-4. Only upon commencement of the next service period, whereby enforceable rights and obligations exist for both parties until the next available termination date (i.e. the end of that period), does a contract for that period exist under Topic 606.

When the *customer only* has a unilateral option to terminate a period-to-period contract, some enforceable rights and obligations continue to exist. That is, the customer has the unilateral right to continue to receive services and the entity an obligation to stand-ready to provide those services if elected by the customer for an optional period. However, because those services are *optional* to the customer, unless they provide the customer with a material right, there is no accounting by the entity for the customer option. The entity only accounts for the current period's services, which are not subject to cancellation, until the customer elects its option to obtain services for the next period (which includes by not canceling the services), creating additional enforceable rights and obligations for the entity – i.e. the customer's decision not to cancel the services creates an enforceable obligation on the entity to provide the services and an enforceable right to receive payment for those services.

Example B130.1

Contract with unspecified term cancellable by either party

ABC Corp. contracts with Customer to provide its SaaS offering for a flat fee of $130 per month, subject to annual increases based on the lesser of 5% or changes in the consumer price index (CPI). $130 is the stand-alone selling price of SaaS at contract inception. The contract term is indefinite and it is cancellable at the end of each month by either party without penalty.

ABC determines that the initial contract term is only one month and that the contract term will always be one month under this arrangement. This is because each subsequent month represents a wholly unperformed contract – that is, each party has the unilateral, enforceable right to terminate the contract at the end of the then-current month without compensating the other party. A new contract will be deemed to exist for purposes of applying Topic 606 each month once each party forgoes its cancellation right for that period.

ABC considers whether Customer's option to renew on an indefinite basis provides it with a material right. Consistent with the discussion in Question C410, ABC concludes the options to renew do not provide Customer with a material right because the renewal price will only be greater than or equal to the stand-alone selling price of the SaaS as of contract inception.

Example B130.2

Contract with a specified term cancellable by either party

ABC Corp. enters into a contract with Customer to transfer a three-year term license to software product G, and provide technical support and unspecified updates, upgrades and enhancements (collectively, PCS) for a one-year period. The stand-alone selling price and the contract price of the term license is $600,000 and the stand-alone selling price and contract price of one year of PCS is $120,000. Customer pays $720,000 in combined fees at contract inception.

Scenario 1: Termination option for only part of the license term

Customer has the option to terminate the contract at the end of any month during the first year after the first month and would be entitled to a pro rata refund of the license and the PCS fees paid. For example, if Customer terminates at the end of Month 6, Customer would be entitled to a refund of 30/36ths of the $600,000 license fee ($500,000) and 6/12ths of the $120,000 PCS fee ($60,000). ABC concludes that while the PCS is a single performance obligation (see Question C150), the PCS is distinct from the software license (see Questions C160 and C170). ABC expects Customer to exercise renewal options to continue PCS for Years 2 and 3 at the same price as for Year 1, but there is no obligation for Customer to do so. After Year 1, Customer is no longer permitted to terminate the software license before the end of the contractual three-year term, even if Customer does not renew PCS.

ABC concludes that the performance obligations in the contract include only a one-month software license and one month of PCS, rather than the three-year term license and one year of PCS outlined in the contract. Because Customer has the enforceable right to cancel the contract at the end of any month during the initial PCS term after Month 1 and receive a pro rata refund, each subsequent month (i.e. beyond Month 1) embodies a customer *option* to continue to license software product G and obtain PCS for an additional fee. Therefore, the contract includes 11 one-month renewal options of the software license and 11 one-month PCS renewal options, and options to renew the product G license for two years at the end of Year 1, and to renew PCS for one year at the end of Year 1 and Year 2.

The license and PCS renewal options do not provide Customer with a material right. ABC reaches this conclusion on the basis that the price of each monthly license and PCS renewal, i.e. during the first year of the contractual license term, is equal to the price of the initial one-month license and PCS (calculated as the contractual fees paid, less the pro rata refund due to Customer if the contract is canceled at the end of Month 1). ABC further notes that the two-year product G renewal option, and the two one-year PCS renewal options are also priced consistently with the initial one-month license/PCS contract, and that Customer is entitled to a full pro rata refund of the license fees for the remaining two years if Customer terminates the license. Therefore, because none of the options grant Customer a material right, each renewal is accounted for as a new, separate contract when exercised (see Question G40).

ABC will recognize the same amount in each month of the first year of the contract:

— on the first day of the month, the revenue attributable to a one-month license to software product G; and
— the revenue attributable to one month of PCS over the course of the month using an appropriate measure of progress (see Question F220).

During the second year of the contract, ABC will recognize:

— on the first day of Year 2, the revenue attributable to the two-year software product G license; and
— the revenue attributable to Year 2 PCS over the course of Year 2 using an appropriate measure of progress.

Over the third year of the contract, ABC will recognize the revenue attributable to the Year 3 PCS using an appropriate measure of progress.

Scenario 2: Termination option for the entire license term

Assume the same facts as in Scenario 1, except that the license and PCS term is three years. Customer pays $720,000 at contract inception ($600,000 for the three-year license and $120,000 for Year 1 of PCS) and pays PCS fees for each subsequent year at the beginning of Year 2 and Year 3. Customer has the right to terminate the license and PCS at the end of each month during the three-year stated term. For example, if Customer terminates the license at the end of month 30, Customer would be entitled to a refund of 6/36ths of the $600,000 license fee ($100,000) and 6/12ths of the Year 3 $120,000 PCS fee paid at the beginning of Year 3 ($60,000).

For the same reasons as in Scenario 1, Customer's options to renew the license for another month each month throughout the contract period, do not grant Customer a material right. Consequently, ABC's revenue recognition will be the same each month during the three-year contract. Each month, ABC will recognize:

- on the first day of the month, the revenue attributable to a one-month license to software product G; and
- the revenue attributable to one month of PCS over the course of the month using an appropriate measure of progress.

Scenario 3: Nonrefundable upfront fee

Assume the same facts as in Scenario 2, except that Customer pays a nonrefundable upfront fee of $960,000 at contract inception for the three-year term license and PCS. The stand-alone selling price and the contract price of the term license is $600,000 and the stand-alone selling price and contract price of three years of PCS is $360,000. Customer has the option to terminate the contract at the end of any month during the three-year term. On termination, the customer is not entitled to a refund and loses the right to use the software.

ABC Corp. accounts for this arrangement as a three-year contract. As discussed in Question B150, the termination right is not substantive because the nonrefundable upfront fee is the only consideration in the contract. In contrast to Scenario 2, the absence of a pro-rata refund option indicates that Customer does not have to make a substantive, separate purchasing decision (i.e. substantive option) at the end of any month about whether to acquire additional software licenses, because it is not deciding whether to exercise a right to spend more money to acquire an additional license and PCS.

ABC Corp. allocates $600,000 to the term license, which is recognized upfront on transfer of control (right to use and benefit from the license) and $360,000 to the PCS, which is recognized using an appropriate measure of progress.

Scenario 4: Refund is unknown

Assume the same facts as in Scenario 2, except that on termination, the contract states that ABC Corp. and Customer will negotiate a refund for Customer.

ABC Corp. accounts for this contract as a three-year contract. Unless ABC Corp. can demonstrate it has enforceable rights and obligations to provide a pro rata refund, the termination right is not substantive, because the customer does not have a separate purchasing decision that it can make without ABC Corp., and therefore the termination right is not similar to a customer option to renew.

ABC Corp. allocates $600,000 to the term license, which is recognized upfront on transfer of control (right to use and benefit from the license) and $360,000 to the PCS, which is recognized using an appropriate measure of progress.

Example B130.3

Term-based license with a reseller with monthly cancellation

ABC Corp. enters into a contract with a reseller to transfer a one-year term license to software product G, and provide technical support and unspecified updates, upgrades and enhancements (collectively, PCS) for a one-year period. ABC Corp. determines that there are two distinct performance obligations (term license and PCS). The stand-alone selling price and the contract price of the term license is $200,000 and the stand-alone selling price and contract price of one year of PCS is $120,000. Customer pays $320,000 in combined fees at contract inception.

The reseller has the option to terminate the contract at the end of any month during the one-year term. On termination, the reseller is entitled to a pro rata refund and loses the right to use the software. In a separate arrangement, the reseller agrees to provide software product G and PCS to a third party end-user for a one-year term. The contract between the reseller and end-user is non-cancellable.

ABC determines that the reseller is the customer and that the reseller takes control of the license and PCS before they transfer to the third party end-user. Further, PCS is provided directly to the reseller and not the third party end-user. The contract between ABC Corp. and the reseller is a principal-to-principal contract.

ABC Corp. accounts for this arrangement as 12 individual monthly contracts, i.e. the lesser of the contractual period of one year and the one-month period in which the contract can be terminated without penalty. Therefore, ABC Corp. would recognize as revenue $26,667 per month for the one-year term (monthly ratable recognition). The options to renew do not provide Customer with a material right because the renewal price will be greater than or equal to the stand-alone selling price of the PCS as of contract inception.

ABC Corp. is not a party to the contract with the third party end-user customer (who is the customer of the reseller) and does not provide services to the end user. ABC Corp.'s customer is the reseller and the contract between reseller and the third party end-user does not affect the conclusion reached on the contract between ABC Corp. and the reseller.

Example B130.4

Perpetual license

ABC Corp. enters into a contract with Customer to transfer a perpetual license to software product G, and provide technical support and unspecified updates, upgrades and enhancements (collectively, PCS) for a three-year period, which is the economic life of the software. ABC Corp. determines that there are two distinct performance obligations (perpetual license and PCS). The stand-alone selling price and the contract price of the perpetual license is $600,000 and the stand-alone selling price and contract price of three years of PCS is $360,000. Customer pays $960,000 in combined fees at contract inception.

Scenario 1: Perpetual license and mandatory PCS with pro rata refund

Customer has the option to terminate the contract at the end of any month. On termination of either the license or PCS, Customer is entitled to a pro rata refund for the PCS and perpetual license and loses the right to use the software. The pro rata refund for the perpetual license is calculated based on the economic life of the license of three years. For example, if Customer terminates the license at the end of month 30, Customer would be entitled to a refund of 6/36ths of the $960,000 license and PCS fees ($160,000).

Question C200 and the examples (C200.1 through C200.3) therein discuss mandatory PCS in which a customer forfeits its rights to a perpetual license if it does not renew PCS. Scenario 1 is similar, as Customer must renew the contract and PCS to maintain the software license. Consistent with Question C200 and the related examples, the option to terminate the contract at the end of each month and obtain a pro rata refund of the PCS license fee results in a one-month contract for a term license and PCS with 35 monthly renewal options.

In this scenario, the renewal period lasts for the economic life of the licensed software and, therefore, we do not believe an additional perpetual license is granted at the end of the term. However, if the economic life of the software was longer than three years, at the end of the three-year term a perpetual license would be granted, which likely indicates that there is a material right. See Question C200 and Example C200.2 on mandatory PCS for further discussion.

Scenario 2: Perpetual license with pro rata refund for PCS only

Assume the same facts as in Scenario 1, except that the contractual price for the perpetual license is $300,000, the PCS price is $360,000, the pro rata refund relates to PCS only (i.e. the license fee is nonrefundable) and the license is not forfeited upon termination. The stand-alone selling price of the perpetual license is $600,000 and the stand-alone selling price of PCS is $360,000.

ABC Corp. accounts for this agreement as a contract for the perpetual license and one month of PCS with 35 individual monthly options to renew the PCS. The total non-cancellable amount of $310,000 is allocated to the upfront perpetual license and one month of PCS based on their relative stand-alone selling prices. Therefore, ABC Corp. would recognize license revenue of $304,918 upfront and PCS of $5,082 in the first month.

ABC allocates the transaction price as follows.

Performance obligation	Contract price	Stand-alone selling price	Selling price ratio	Price allocation
Perpetual license	$300,000	$600,000	98.36%	$304,918
PCS	10,000[1]	10,000	1.64%	5,082
Total	**$310,000**	**$610,000**	**100.00%**	**$310,000**

Note:

1. $10,000 is the non-cancellable amount of the PCS fee for the current month (i.e. if the contract is terminated at the end of month 1, Customer would be entitled to a refund of 35/36ths of the $360,000 PCS fee ($350,000)).

Each month thereafter, ABC Corp would recognize $10,000 in PCS revenue. Note that this treatment results in an accounting model that is capped by the cash amounts collected.

Example B130.5

Presentation of prepayment liability for cancellable contracts

On June 30, Year 1, Software Host enters into a contract with Customer to provide Customer with access to its hosted application for three years on a software-as-a-service (SaaS) basis. It concludes that its performance obligation to provide SaaS is satisfied over time because Customer receives and consumes benefits from the hosted application, as Software Host provides that access.

Software Host charges $180,000 a year for access to its hosted application, required to be prepaid at the start of each contractual year. The contract includes a provision that allows Customer to terminate the contract without penalty at the end of any designated month in exchange for a pro rata refund of its prepayment. Software Host concludes that a contract does not exist for periods beyond the then-current month.

The prepayment liability is presented as a deposit liability and not a contract liability. Because the contract term does not exist beyond the then-current month, there is no obligation to transfer a future month of hosting until Customer chooses to renew the contract for the subsequent month by not exercising its right to terminate. The deposit liability is presented separately from contract liabilities in the balance sheet.

Question B140

How does a termination penalty affect the assessment of the contract term?

Interpretive response: It may be the case that services provided under a contract can be terminated only by compensating the other party. For example, one party may be required to pay the other a termination penalty, which may be characterized explicitly as a termination penalty or otherwise characterized (e.g. as a requirement to either (1) continue to pay the contractual fees for a period of time even after services are no longer being provided or (2) forfeit of an otherwise refundable deposit paid to the entity upfront). If the right to compensation in the event of termination is substantive, then the duration of the contract is the *shorter of* the stated term or the period up to the point at which the contract can be terminated without paying substantive compensation.

A substantive termination penalty that compensates the other party is evidence that enforceable rights and obligations exist throughout the entire stated term. In other words, only by paying the penalty is the terminating party relieved of its remaining enforceable obligations, and only in return for that compensation does the non-terminating party forgo its remaining enforceable rights.

Discussions of the TRG at the November 2015 meeting concluded that entities should reach the same conclusion as outlined in the preceding paragraphs regardless of whether both entities have the right to terminate the contract or only the customer. Therefore, if only the customer has the right to terminate the contract in return for paying a substantive penalty, the contract term is the shorter of the stated term or the period up to the point at which the customer has the right to terminate the contract without paying a substantive penalty.

In making the assessment of whether a termination penalty is substantive, an entity considers all relevant factors, including whether the penalty is insignificant. A penalty that is insignificant would generally not change the enforceable rights or obligations of the parties from those that would exist absent the requirement to pay a penalty.

The substantive evaluation would also generally include consideration of the legal enforceability of the right to compensation on termination. For example, depending on the facts and circumstances, an entity's past practice of not enforcing termination penalties (e.g. allowing customers to terminate the contract without enforcing collection of the termination penalty) *may* result in a conclusion that the termination penalty is not enforceable under the relevant laws of the jurisdiction governing the contract. These types of circumstances may require legal analysis. *If* the entity's past practice makes its right to compensation upon termination (and the customer's obligation to pay that amount) unenforceable based on the applicable laws and regulations, then the entity would assess the contract term as it would for a contract without a termination penalty (see Question B130). In contrast, if the entity's past practice does not change the parties' legally enforceable rights and obligations, then that past practice would not affect whether the termination penalty is substantive.

When a cancellation occurs

If a cancellation occurs during the contract term determined in accordance with the first paragraph of this question (e.g. the customer terminates the contract regardless of having to pay a substantive termination penalty), the termination is accounted for as a contract modification as it changes the scope of the contract by shortening it.

Example B140.1

Past practice of allowing customers to terminate without enforcing collection of the termination penalty

ABC Corp. enters into a contract to provide services to Customer for 24 months. Customer has the enforceable right to terminate the contract by paying a substantive penalty to ABC. The penalty does not change during the contract term. ABC has a past practice of allowing customers to terminate substantially similar contracts after 12 months without enforcing collection of the termination penalty.

Because the termination penalty is substantive, it affects the enforceable rights and obligations under the contract for both parties such that the contract term is the shorter of the 24 month stated term or the period for which Customer must pay a *substantive* termination penalty.

The period during which Customer must pay a substantive penalty may be affected by ABC's past practice of not enforcing the termination penalty after 12 months if that past practice is considered to restrict its legal right to enforce the termination penalty, or Customer's legal obligation to pay, after 12 months. The determination in this regard could vary depending on the laws and regulations of the jurisdiction governing the contract and potentially other factors.

If ABC's past practice does *not* change its enforceable rights (and, correspondingly Customer's enforceable obligations), the contract term will be the full 24-month stated term. However, if ABC's past practice results in the conclusion that the termination penalty is not enforceable under the relevant laws and regulations of the governing jurisdiction, the contract term is only 12 months – that is, the period during which a substantive penalty applies.

Example B140.2
Contract term with decreasing termination penalty

ABC Corp. enters into a four-year contract with Customer to provide SaaS. The contract requires Customer to pay an annual fee of $100. Customer can terminate the contract at any point without cause, but until year 4 would incur a termination penalty. ABC always enforces its right to receive a termination penalty. The penalty decreases annually throughout the contract term. The following table illustrates the payments under the contract, as well as the termination penalty that would apply during each year of the stated contract term.

	Year 1	Year 2	Year 3	Year 4
Annual fee	$100	$100	$100	$100
Termination penalty	30	20	10	-
Cumulative fee if customer cancels in this year	**$130**	**$220**	**$310**	**$400**

ABC concludes that the penalty is substantive as it is neither insignificant, nor is there any question as to the enforceability of the termination penalty. In this example, the termination penalty represents at least 10% of the remaining annual fees (in aggregate) in the periods subsequent to the period in which the contract is terminated until it goes away in year 4, which ABC concludes is not an insignificant penalty.

ABC determines that the contract term is three years under Topic 606. Three years is the shorter of the stated contract term (four years) and the period during which a substantive termination penalty applies to any Customer cancellation (three years).

The termination penalty does not affect ABC's accounting for the three-year contract (i.e. no portion of the penalty is factored into the transaction price of the contract, nor does the penalty change that ABC's performance obligation is to provide the SaaS for three years) unless the contract is terminated, at which point the termination will be accounted for as a modification of the contract.

Question B150

Does forfeiture of a significant upfront fee constitute a termination penalty?

Interpretive response: It depends. A customer may pay a significant upfront fee that it would forfeit upon termination of the contract. Whether forfeiture of this fee constitutes a termination penalty depends on whether the fee would be refundable if the contract is not terminated.

Upfront fee is refundable. In general, forfeiture of an upfront fee does not constitute a termination penalty unless the customer would be entitled to a refund of that fee if it does not terminate the contract. For example, if a customer pays a $100 upfront fee to an entity at the beginning of a four-year contract, and will receive that fee (or a significant portion thereof) back only if it chooses not to exercise a termination right, we believe the requirement to forfeit the upfront fee is no different from having to pay a $100 fee upon termination.

Upfront fee is nonrefundable. If an upfront fee is nonrefundable, its forfeiture generally does not constitute a termination penalty because the refundability is not contingent on termination. Instead, an entity generally considers whether payment of the fee provides the customer with a material right with respect to renewing the services (including by not electing an option to cancel the services). Whether payment of a nonrefundable upfront fee provides the customer with a material right upon renewal of a services contract is discussed in Question C410.

Notwithstanding that the non-refundable fee generally does not constitute a termination penalty, there are fact patterns where the customer's ability to terminate a contract with an upfront fee does not affect the contract term. This would be the case if a nonrefundable upfront fee is the only consideration in a contract that meets the contract existence criterion. In that case, the customer does not have a separate purchasing decision to make with respect to renewing (i.e. by not terminating) the contract because it has prepaid, on a nonrefundable basis, for all the goods or services promised in the contract. Therefore, the termination option is not substantive, and any contractual termination right does not affect the contract term and a material rights analysis would not be performed. For example, a one-year service contract where the customer pays a nonrefundable upfront fee that is the only consideration would be considered a one-year contract regardless of whether the customer could technically terminate the contract.

Question B160

Does a cancellation provision exist if the contract is silent as to cancellation or termination?

Interpretive response: In general, if a contract does not provide for cancellation or termination, the entity should generally conclude the contract term is the stated term in the contract. However, as discussed in paragraph 606-10-25-3, the duration of a customer contract (i.e. the contractual period) is dictated by the present enforceable rights and obligations of the parties to the contract. Therefore, it may be that a legally enforceable cancellation or termination provision exists even if the written contract is silent in this regard. *If* such a provision exists, entities still need to consider whether a termination penalty would apply (see Questions B140 and B150).

Question B170

Does a cancellation provision available only upon a substantive breach of contract affect the contract term?

Interpretive response: No. If a contract exists under Topic 606, that means the parties can identify their rights and obligations under the contract and are committed to perform their respective obligations – see paragraph 606-10-25-1. Therefore, if a contract exists, an entity would not assume that a substantive breach of contract will occur when determining the contract term.

Question B180

Does a contract exist during 'free-trial' periods before the customer accepts an offer to continue the services beyond the free-trial period?

Interpretive response: Entities such as SaaS providers frequently offer customers the right to obtain their services for free for a period of time (i.e. a 'free-trial period') during which the customer can decide to contract for the services going forward (e.g. the customer can decide to obtain the entity's SaaS for 12 or 36 months after the end of the free-trial period). SaaS providers frequently offer additional incentives (e.g. free or discounted professional services or a discounted price of the SaaS) if the customer enters into a long-term contract for the entity's SaaS.

Some stakeholders in the United States asked the question about what services would be sales incentives and what services would be part of a contract with a customer if the customer accepts the entity's offer before the free-trial period ends. Based on discussions with the FASB staff, it is our understanding that their view is that services provided during a free-trial period, before the customer accepts the entity's offer to provide services beyond the free-trial period, should be accounted for as sales incentives. No contract exists until the customer accepts the entity's offer to provide services after the free-trial period because the customer can opt-out anytime during the free-trial period. That is, no enforceable right to consideration exists for the entity until the customer contracts for post-trial period services. Once the customer accepts the entity's offer, the entity should account for remaining free trial period services (from the date a contract exists) *and* the post-free trial services as committed performance obligations of the contract.

The FASB staff further indicated that, in limited circumstances, it may be reasonable to account for only the post-free trial period goods or services (i.e. those that were part of the offer to the customer) as performance obligations of the customer contract. The staff indicated this would be the case only if either (1) the customer's right to the remaining free-trial period goods or services was not enforceable, or (2) on a portfolio basis, accounting for only the post-free trial period goods or services as performance obligations would not materially differ from accounting for both the remaining free trial period goods or services *and* the post-free trial period goods or services as performance obligations of the contract with the customer.

Example B180.1
Free-trial period

ABC Corp. offers three free months of its SaaS to Customer. At any time during the three-month free-trial period, Customer can decide to continue the SaaS for 12 months after the end of the three-month free-trial period for a fee of $12,000, payable $1,000 in advance of each month during the 12-month post-trial period.

ABC's accounting for this contract depends on *when* Customer accepts ABC's offer to provide 12 months of its SaaS after the end of the free-trial period. For example:

— If Customer accepts and agrees to pay for the post-trial period services on Day 1 of the free-trial period, ABC's performance obligation is to provide 15 months of SaaS for $12,000 and, therefore, would recognize $800 each of the 15 months that SaaS is provided under the contract ($12,000 ÷ 15 months = $800). None of the cost of providing the SaaS during the free-trial period would be recognized as a sales and marketing expense.

— If Customer accepts and agrees to pay for the post-trial period services at the beginning of the third month of the three-month free-trial period, ABC's performance obligation is to provide 13 months of its SaaS for $12,000 and, therefore, would recognize $923 each of the 13 months that SaaS is provided under the contract ($12,000 ÷ 13 months = $923). The cost of providing the first two months of the SaaS during the free-trial period would be recognized as a sales and marketing expense.

— If Customer accepts and agrees to pay for the post-trial period SaaS on the last day of the three-month free-trial period, ABC's performance obligation is to provide 12 months of SaaS for $12,000 and, therefore, would recognize $1,000 each of the 12 months that SaaS is provided under the contract ($12,000 ÷ 12 months = $1,000). The cost of providing the three free-trial months of the SaaS would be recognized as a sales and marketing expense.

Note that in either of the first two scenarios, ABC would be recognizing revenue on the SaaS before it is legally entitled to receive any consideration from Customer. For example, in the first scenario, ABC will recognize $2,400 before it is legally permitted to bill Customer for the SaaS. ABC's offsetting entry is to a contract asset, which ABC will derecognize over the 12-month contract period once it begins to bill Customer under the terms of the contract.

Alternatively, it *may* be reasonable, regardless of when Customer accepts and agrees to pay for the post-trial period services, to consider ABC's performance obligation as one to provide 12 months of post-trial period SaaS for $12,000. In that case, ABC would recognize $1,000 each of the 12 months that SaaS is provided under the contract ($12,000 ÷ 12 months = $1,000). The cost of providing the remaining free-trial months of the SaaS would be recognized as a sales and marketing expense. This alternative would only be appropriate if either:

a. ABC does not have an enforceable obligation, as a result of entering into the contract with Customer, to provide the remaining free-trial period SaaS, or
b. ABC has a number of similar contracts that would permit it to apply this accounting on a portfolio approach basis (i.e. on a portfolio basis, accounting for committed free-trial period SaaS as a sales and marketing cost for contracts in the portfolio would not materially affect the entity's accounting results).

Comparison to legacy US GAAP

Under legacy US GAAP, arrangement consideration is limited to only non-contingent amounts (often referred to as the 'contingent cash cap'). That means, in a SaaS contract that provides the customer with three free or six discounted months of service or discounted implementation services, revenue recognized as those free or discounted services are provided is limited to amounts that are not contingent on the provision of future services.

Topic 606 has no prohibition on recognizing contingent revenue. Entities applying the approach illustrated as Alternative 1 in Example B180.1 will generally allocate more revenue to free or discounted services provided at the outset of a contract than they do under legacy US GAAP, which will accelerate overall revenue recognition under contract.

Combining contracts

Question B190

What constitutes 'at or near the same time' when evaluating whether two or more contracts should be combined?

Interpretive response: Topic 606 does not provide a 'bright line' for evaluating what constitutes 'at or near the same time' to determine whether two or more contracts should be combined. Therefore, we believe an entity might adopt an accounting policy as to what represents a minimum period of time that would evidence two or more contracts were entered into 'at or near the same time'. Many entities have had an accounting policy under legacy US GAAP in this regard, and that policy *may* remain reasonable under Topic 606, provided that policy (or any new policy) appropriately considers the entity's customary business practices and other reasonable expectations, such as recent changes to contracting practices or licenses/services offered. For example, an entity may perform services for a majority of the customers that license its software products or obtain its software-as-a-service and have a business practice of entering into follow-on contracts to provide those services. In this scenario, the entity might specifically consider the period of time that generally elapses between the initiation of the contract for the software license or the SaaS and the follow-on contract for the services in determining what represents a *minimum* period of time within which the entity would conclude two or more contracts were entered into at or near the same time.

However, just because two contracts are not entered into within the minimum period of time established by the entity does not mean they were not entered into 'at or near the same time'. An entity should have processes in place that consider specific facts and circumstances in cases that may not be 'customary' or usual. For example, an entity should not ignore the fact that two non-standard agreements, such as ones that are different from or larger than the entity's typical arrangements, were being discussed or negotiated over the same period of time and would appear to be significantly interrelated solely because they were not executed within the entity's established 'minimum period'.

An entity should establish procedures to ensure multiple contracts initiated with the same customer at or near the same time are identified on a timely basis and, therefore, appropriately considered as to whether they should be accounted for as a single contract.

Question B200

If an entity and/or its customer have multiple divisions (business units), should contracts entered into between different divisions be evaluated for possible combination?

Interpretive response: Yes. There is no exception for considering whether two or more contracts should be combined because they were executed by different divisions of the entity and/or the customer; in fact, contracts with related parties of the customer that are not part of the same consolidated entity are considered for possible combination. However, whether the contracts were negotiated by the same parties or, instead, were negotiated with different divisions of the entity or the customer may influence whether any of the three specified criteria in paragraph 606-10-25-9 are met. For example, two contracts entered into by different divisions of one or both parties *may* be less likely to have been 'negotiated as a package with a single commercial objective' or to have goods or services that are a single performance obligation.

Question B210

Are the criteria in paragraph 606-10-25-9 similar to the indicators of contract combination in legacy US GAAP?

Interpretive response: Legacy US GAAP software revenue recognition guidance included a series of indicators to consider when determining whether two or more contracts should be combined. Because the contract combination guidance in Topic 606 is similar in concept to that in legacy US GAAP, we believe it is useful to consider how the legacy US GAAP indicators, with which entities should be familiar, compare to the specified contract combination *criteria* in Topic 606. The following table describes the similarities between the indicators under the legacy US GAAP software revenue recognition guidance and the specified criteria under Topic 606. Note that there were six indicators in the legacy US GAAP guidance, and some of them relate to more than one of the Topic 606 criteria.

Indicator under legacy software guidance (para 985-605-55-4)	**Related criterion (or criteria) under Topic 606** (para 606-10-25-9)
a. The contracts or agreements are negotiated or executed within a short timeframe of each other.	The first criterion in Topic 606 for determining when an entity combines two or more contracts and accounts for them as a single contract is that the contracts have to be entered into at or near the same time. This indicator is similar to that first criterion.
b. The different elements are closely interrelated or interdependent in terms of design, technology or function.	a. The contracts were negotiated as a package with a single commercial objective; and/or

Indicator under legacy software guidance (para 985-605-55-4)	Related criterion (or criteria) under Topic 606 (para 606-10-25-9)
	c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.
c. The fee for one or more contracts or agreements is subject to refund, forfeiture or other concession if another contract is not completed satisfactorily.	b. The amount of consideration to be paid in one contract depends on the price or performance of the other contracts.
d. One or more elements in one contract or agreement are essential to the functionality of an element in another contract or agreement.	a. The contracts are negotiated as a package with a single commercial objective; and/or c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.
e. Payment terms under one contract or agreement coincide with performance criteria of another contract or agreement.	b. The amount of consideration to be paid in one contract depends on the price or performance of the other contracts.
f. The negotiations are conducted jointly with two or more parties (e.g. from different divisions of the same entity) to do what in essence is a single project.	a. The contracts are negotiated as a package with a single commercial objective; and/or c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.

The preceding table is just a 'bridge' between the legacy and the new guidance. Just like under legacy US GAAP, significant judgment will be required in many cases to determine if one or more of the criteria in paragraph 606-10-25-9 are met. And while, as outlined in the preceding table, there is a relationship between the legacy indicators and the new criteria, that relationship does not mean a particular Topic 606 criterion will be evaluated in the same way as the legacy US GAAP indicator. For example, as discussed in *Chapter C – Step 2: Identify the performance obligations in the contract*, an entity may reach different conclusions under legacy US GAAP about whether an element is 'essential to the functionality' or 'closely interrelated or interdependent in terms of design, technology or function' to another element and whether two or more promised goods or services are distinct from each other under Topic 606.

An entity should establish processes and controls to be able to identify multiple contracts entered into with the same customer on a timely manner to ensure that the entity is appropriately determining whether such contracts should be combined. This may include processes and controls to identify ongoing negotiations between the entity and the customer so that revenue related to a contract is not recognized until the entity has evaluated whether the contract(s) under negotiation should be combined.

Example B210.1

Combining contracts, Part I

ABC Corp. licenses trust asset management system software called Product B. The Product B software enables users, typically large financial institutions, to access and value individual US dollar denominated trust account portfolios on a real-time basis. Product B functions as designed without any customization or modification services and can be implemented without ABC's assistance in most cases.

ABC entered into a specific contract with Customer, a large international commercial bank, to grant a license to the Product B software and, approximately 45 days later, enters into a separately papered agreement to provide services to modify the customer's instance of the software. The services include modification of the software code and configuration of certain modified and off-the-shelf settings to allow Customer to access and value its trust account portfolios in multiple foreign currencies.

While executed separately, the two agreements were negotiated during the same time period (even though commencement and completion of the negotiations of each were not co-terminus) and largely by the same ABC and Customer personnel.

ABC concludes that, if the two contracts were combined, the license to Product B and the professional services to customize and configure the licensed software would be a single performance obligation (see Question C230 and Example C230.1). ABC also concludes that the two agreements were negotiated as a package with a single commercial objective – i.e. to enable Customer to use ABC's software across its international operations.

Therefore, because the software license agreement and the services agreement were entered into near the same time, the two agreements constitute a single contract and ABC will account for the Product B license and the professional services as a single performance obligation.

Example B210.2
Combining contracts, Part II

Assume the same facts as in Example B210.1 except for the following:

- The services agreement is executed nearly five months after the software license agreement.
- The size of the two agreements and the extent of the services are larger than any other arrangement ABC has entered into in recent years.
- ABC has an accounting policy, based on its customary business practices, that contracts entered into within 90 days of each other have been entered into 'at or near the same time'.

Consistent with Example B210.1, ABC concludes both:

- That if the two contracts were combined, the license to Product B and the professional services to customize and configure the licensed software would be a single performance obligation (see Question C230); and
- The two agreements were negotiated as a package with a single commercial objective – that is, to enable Customer to use ABC's software across its international operations.

In this case, ABC concludes the two agreements were entered into near the same time as each other even though five months is longer than its established policy of treating 90 days or less as 'at or near the same time'. Consistent with the discussion in Question B190, even though ABC has an accounting policy in this regard that is reasonable to ABC's customary customer arrangements, ABC considers that this is an 'atypical' customer arrangement – i.e. it is unusually large and complex – such that the specific facts and circumstances should also be considered. The significantly overlapping negotiations and negotiating parties, along with the overall context of the two agreements, leads ABC to conclude that a delay in obtaining final agreement on the services contract does not mean that contract and the license agreement were not entered into near the same time as each other.

Example B210.3
Combining contracts, Part III

ABC Corp. enters into a software license agreement with Customer to license Product E. Product E is fully functional upon basic installation that most customers can perform themselves or obtain from numerous service providers other than ABC. However, approximately one month after the license agreement is concluded, Customer decides that it wants ABC to provide some services so that Customer can more effectively use the Product E software. Consequently, ABC and Customer enter into a services agreement for ABC to provide specified implementation and configuration services.

The implementation and configuration services are not complex; ABC will build some simple interfaces, configure available features in the Product E software to Customer's specifications, and then perform some user acceptance testing to ensure everything works as intended. However, Customer views the services as important to its ability to immediately begin using the Product E software as intended such that when it concludes the services agreement, Customer requires inclusion of a clause that states Customer is permitted to withhold up to 50% of installment license fees required under the software license agreement until the services are successfully completed and accepted.

Even though there are two agreements, they were executed near the same time – that is, only approximately one month apart – and the services agreement effectively modifies the license agreement by changing its payment terms (i.e. permitting a delay in Customer's payments due under the license agreement until the services agreement is fulfilled successfully). In addition, the consideration to be paid for the Product E software license is dependent on the successful completion of the implementation and configuration services in the services agreement. Therefore, ABC concludes that the license agreement and the services agreement should be combined for accounting purposes under Topic 606. It is important to note, however, that just because ABC concludes that the agreements should be combined, it does not necessarily follow that the Product E software license and the implementation/configuration services are a single performance obligation in the combined contract. For further discussion on identifying the performance obligations in a contract (i.e. Step 2 of the model), see *Chapter C – Step 2: Identify the performance obligations in the contract*.

Question B220

Can contracts entered into at or near the same time with multiple customers be combined?

Interpretive response: No. The FASB considered whether to specify that all contracts should be combined if they were negotiated as a package to achieve a single commercial objective, regardless of the customer. However, the FASB decided against this approach because it was concerned that doing so could have the unintended consequence of an entity combining too many contracts and not faithfully depicting the entity's performance. [ASU 2014-09.BC75]

Further, in an SEC staff speech, it was noted that the SEC's Office of the Chief Accountant had been consulted on the contract combination guidance. It was noted that because Topic 606 explicitly limits what contracts may be combined, the staff objected to a registrant's proposal to extend the contract combination guidance beyond contracts with the same customer or related parties of the same customer. [2016 Baruch]

Question B230

Do purchase orders under the same MSA need to be combined?

Interpretive response: It depends. Even if the MSA is not legally enforceable, the pricing among the purchase orders may be interrelated and required to be combined into a single contract. As a consequence, purchase orders that are issued separately should be evaluated and combined if the criteria for combining contracts are met.

For example, if an entity receives two separate purchase orders at or near the same time for units to be delivered in Month 1 and Month 2, then the entity assesses whether the purchase orders were negotiated as a single commercial package – e.g. price adjustments were made for cash flow reasons – or independent of one another.

If the purchase orders are combined, this may result in the transaction price allocated to performance obligations in an individual purchase order being different from the stated contract price. For example, assume a customer submits two purchase orders that are combined for 200 software seats each to be transferred in Month 1 and Month 2 and stated the unit prices are $100 in Month 1 and $80 in Month 2. In that scenario, the transaction price allocated to each software seat would likely be $90 if the stand-alone selling price is the same for each unit.

When purchase orders are not combined, the MSA may contain implicit or explicit promises that are relevant to other steps in the revenue model. This includes considering whether the pricing on subsequent purchase orders may include a material right under Step 2 or any variable consideration under Step 3 (e.g. a rebate or discount) that are not disclosed in the purchase orders.

C. Step 2: Identify the performance obligations in the contract

Questions and Examples

New item added to this chapter: **
Item significantly updated in this edition: #

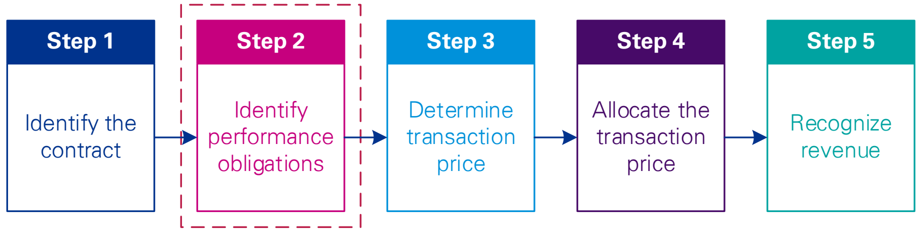
Identify the promised goods and services

Determine which promised goods or services are performance obligations

A series of distinct goods or services

Questions & answers

Customer options



Identify the promised goods and services

Excerpt from ASC 606-10

>> Promises in Contracts with Customers

25-16 A **contract** with a **customer** generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the promised goods and services identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer.

25-16A An entity is not required to assess whether promised goods or services are **performance obligations** if they are immaterial in the context of the contract with the customer. If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, then the related costs to transfer those goods or services shall be accrued.

25-16B An entity shall not apply the guidance in paragraph 606-10-25-16A to a customer option to acquire additional goods or services that provides the customer with a material right, in accordance with paragraphs 606-10-55-41 through 55-45.

25-17 Promised goods or services do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not promised goods or services in the contract with the customer.

25-18 Depending on the **contract**, promised goods or services may include, but are not limited to, the following:

a. Sale of goods produced by an entity (for example, inventory of a manufacturer)

b. Resale of goods purchased by an entity (for example, merchandise of a retailer)
c. Resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal, as described in paragraphs 606-10-55-36 through 55-40)
d. Performing a contractually agreed-upon task (or tasks) for a **customer**
e. Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides
f. Providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party, as described in paragraphs 606-10-55-36 through 55-40)
g. Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
h. Constructing, manufacturing, or developing an asset on behalf of a customer
i. Granting licenses (see paragraphs 606-10-55-54 through 55-6555-60 and paragraphs 606-10-55-62 through 55-65B)

Granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs 606-10-55-41 through 55-45).

Excerpt from ASC 606-10

>>> Other Licensing Considerations

55-64 Contractual provisions that explicitly or implicitly require an entity to transfer control of additional goods or services to a customer (for example, by requiring the entity to transfer control of additional rights to use or rights to access intellectual property that the customer does not already control) should be distinguished from contractual provisions that explicitly or implicitly define the attributes of a single promised license (for example, restrictions of time, geographical region, or use). Attributes of a promised license define the scope of a customer's right to use or right to access the entity's intellectual property and, therefore, do not define whether the entity satisfies its **performance obligation** at a point in time or over time and do not create an obligation for the entity to transfer any additional rights to use or access its intellectual property.

55-64A Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorized use do not affect whether a license provides a right to access the entity's intellectual property or a right to use the entity's intellectual property. Similarly, a promise to defend a patent right is not a promised good or service because it provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract.

>>> Example 61B—Distinguishing Multiple Licenses from Attributes of a Single License

55-399K On December 15, 20X0, an entity enters into a contract with a customer that permits the customer to embed the entity's functional intellectual property in two classes of the customer's consumer products (Class 1 and Class 2) for five years beginning on January 1, 20X1. During the first year of the license period, the customer is permitted to embed the entity's intellectual property only in Class 1. Beginning in Year 2 (that is, beginning on January 1, 20X2), the customer is permitted to embed the entity's intellectual property in Class 2. There is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period. There are no other promised goods or services in the contract. The entity provides (or otherwise makes available —for example, makes available for download) a copy of the intellectual property to the customer on December 20, 20X0.

55-399L In identifying the goods and services promised to the customer in the contract (in accordance with guidance in paragraphs 606-10-25-14 through 25-18), the entity considers whether the contract grants the customer a single promise, for which an attribute of the promised license is that during Year 1 of the contract the customer is restricted from embedding the intellectual property in the Class 2 consumer products), or two promises (that is, a license for a right to embed the entity's intellectual property in Class 1 for a five-year period beginning on January 1, 20X1, and a right to embed the entity's intellectual property in Class 2 for a four-year period beginning on January 1, 20X2).

55-399M In making this assessment, the entity determines that the provision in the contract stipulating that the right for the customer to embed the entity's intellectual property in Class 2 only commences one year after the right for the customer to embed the entity's intellectual property in Class 1 means that after the customer can begin to use and benefit from its right to embed the entity's intellectual property in Class 1 on January 1, 20X1, the entity must still fulfill a second promise to transfer an additional right to use the licensed intellectual property (that is, the entity must still fulfill its promise to grant the customer the right to embed the entity's intellectual property in Class 2). The entity does not transfer control of the right to embed the entity's intellectual property in Class 2 before the customer can begin to use and benefit from that right on January 1, 20X2.

55-399N The entity then concludes that the first promise (the right to embed the entity's intellectual property in Class 1) and the second promise (the right to embed the entity's intellectual property in Class 2) are distinct from each other. The customer can benefit from each right on its own and independently of the other. Therefore, each right is capable of being distinct in accordance with paragraph 606-10-25-19(a)). In addition, the entity concludes that the promise to transfer each license is separately identifiable (that is, each right meets the criterion in paragraph 606-10-25-19(b)) on the basis of an evaluation of the principle and the factors in paragraph 606-10-25-21. The entity concludes that it is not providing any integration service with respect to the two rights (that is, the two rights are not inputs to a combined output with functionality that is different from the functionality provided by the licenses independently), neither right significantly modifies or customizes the other, and the entity can fulfill its promise to transfer each right to the customer independently of the other (that is, the entity could transfer either right to the customer without transferring the other). In addition, neither the Class 1 license nor the Class 2 license is integral to the customer's ability to use or benefit from the other.

55-399O Because each right is distinct, they constitute separate performance obligations. On the basis of the nature of the licensed intellectual property and the fact that there is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period, each promise to transfer one of the two licenses in this contract provides the customer with a right to use the entity's intellectual property and the entity's promise to transfer each license is, therefore, satisfied at a point in time. The entity determines at what point in time to recognize the revenue allocable to each performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Because a customer does not control a license until it can begin to use and benefit from the rights conveyed, the entity recognizes revenue allocated to the Class 1 license no earlier than January 1, 20X1, and the revenue on the Class 2 license no earlier than January 1, 20X2.

Excerpt from ASC 606-10

>>> Example 44—Warranties

55-309 An entity, a manufacturer, provides its customer with a warranty with the purchase of a product. The warranty provides assurance that the product complies with agreed-upon specifications and will operate as promised for one year from the date of purchase. The contract also provides the customer with the right to receive up to 20 hours of training services on how to operate the product at no additional cost. The training services will help the customer optimize its use of the product in a short time frame. Therefore, although the training services are only for 20 hours and are not essential to the customer's ability to use the product, the entity determines that the training services are material in the context of the contract on the basis of the facts and circumstances of the arrangement.

55-310 The entity assesses the goods and services in the contract to determine whether they are distinct and therefore give rise to separate performance obligations.

55-311 The product and training services are each capable of being distinct in accordance with paragraphs 606-10-25-19(a) and 606-10-25-20 because the customer can benefit from the product on its own without the training services and can benefit from the training services together with the product that already has been transferred by the entity. The entity regularly sells the product separately without the training services.

55-312 The entity next assesses whether its promises to transfer the product and to provide the training services are separately identifiable in accordance with paragraphs 606-10-25-19(b) and 606-10-25-21. The entity does not provide a significant service of integrating the training services with the product (see paragraph 606-10-25-21(a)). The training services and product do not significantly modify or customize each other (see paragraph 606-10-25-21(b)). The product and the training services are not highly interdependent or highly interrelated as described in paragraph 606-10-25-21(c). The entity would be able to fulfill its promise to transfer the product independent of its efforts to subsequently provide the training services and would be able to provide training services to any customer that previously acquired its product. Consequently, the entity concludes that its promise to transfer the product and its promise to provide training services are not inputs to a combined item and, therefore, are each separately identifiable.

55-313 The product and training services are each distinct in accordance with paragraph 606-10-25-19 and therefore give rise to two separate performance obligations.

55-314 Finally, the entity assesses the promise to provide a warranty and observes that the warranty provides the customer with the assurance that the product will function as intended for one year. The entity concludes, in accordance with paragraphs 606-10-55-30 through 55-35, that the warranty does not provide the customer with a good or service in addition to that assurance and, therefore, the entity does not account for it as a performance obligation. The entity accounts for the assurance-type warranty in accordance with the requirements on product warranties in Subtopic 460-10.

55-315 As a result, the entity allocates the transaction price to the two performance obligations (the product and the training services) and recognizes revenue when (or as) those performance obligations are satisfied.

Step 2 of the revenue model requires an entity to identify the promised goods or services in the contract with a customer, and then determine which are separate 'performance obligations'.

Therefore, the first task in applying this step of the revenue model is to identify the goods or services promised in a contract with a customer. Such promises can be explicit in the contract or implied based on the entity's actions, including its customary business practices, published policies, and other statements or communications such that the customer has a reasonable expectation of receiving those goods or services as a result of entering into the contract. Promised goods or services in a contract with a customer also include explicit or implicit promises to provide goods or services to the customer's customers, often referred to as sales incentives (e.g. a software entity that implicitly promises, through its customary business practices, to provide technical support or unspecified updates/upgrades to entities that purchase its software from a reseller or distributor).

Promised goods or services do not include set-up activities or administrative tasks that an entity will undertake to fulfill a contract unless those activities or tasks transfer a good or service to the customer. Determining whether activities required to fulfill a contract are promised services to the customer, rather than administrative tasks/set-up activities, requires judgment based on the specific nature of the activities. In general, administrative tasks (or set-up activities) provide no incremental benefit to the customer beyond enabling that customer to obtain a promised good or service – that is, the activities provide no value to the customer separate from the promised good or service the activities permit the customer to obtain, even if those activities are necessary for the customer to obtain the good or service. For example, a software-as-a-service (SaaS) provider may have to undertake activities at the outset of a SaaS arrangement that provide no benefit or value to the customer other than enabling them to access the online service (see Question C220). A strong indicator that activities are not administrative tasks or set-up activities, but rather transfer a promised good or service, is if another party provides those activities separately. If another service provider sells those activities separately that would strongly indicate the activities the entity is providing transfer a promised service to the customer.

An entity is permitted, as a practical expedient, *not* to assess whether promised goods or services are performance obligations if they are 'immaterial in the context of the contract with the customer'. An entity is not required to consider whether promised goods or services that are immaterial in the context of the contract are material in the aggregate. The evaluation of whether a promised good or service is immaterial in the context of the contract considers *both quantitative* and *qualitative* factors. If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, then the related costs to transfer those goods or services are accrued when (or as) the revenue related to the performance obligation that includes those immaterial goods or services is recognized.

Customer options (discussed in further detail before Question C380) that are determined to provide the customer with a 'material right' cannot be deemed immaterial in the context of the contract.

Even if goods or services are not immaterial in the context of the contract, an entity may conclude that accounting for such goods or services are immaterial to the financial statements taken as a whole, similar to the conclusion many entities reach with respect to not capitalizing items of property, plant and equipment below a certain threshold.

Comparison to legacy US GAAP

The concept of a 'promised good or service' in Topic 606 is similar (but not necessarily identical) to the notion of a 'deliverable' under existing US GAAP – although neither term is defined. Therefore, entities may evaluate whether an item in a contract with a customer transfers a promised good or service similarly to how they evaluate whether an item is a deliverable under legacy US GAAP. In an SEC staff speech (Mark S. Barrysmith speech at the 2007 AICPA National Conference on Current SEC and PCAOB Developments), the SEC staff noted that the following criteria are a helpful starting point in determining, under legacy US GAAP, whether an item is a deliverable in the arrangement:

1. the item is explicitly referred to as an obligation of the entity in a contractual arrangement;
2. the item requires a distinct action by the entity;
3. if the item is not completed, the entity would incur a significant contractual penalty; or
4. including or excluding the item from the arrangement would cause the arrangement fee to vary by more than an insignificant amount.

Implied promises/sales incentives

Applying Topic 606 should generally be consistent with the legacy US GAAP software revenue recognition practice. That guidance required software entities that provide technical support services to a reseller's customer, or grant a reseller the right to provide upgrades and enhancements to the reseller's customer, to account for those services as an implied deliverable in the arrangement between the software entity and the reseller.

Administrative tasks/set-up activities

The notion of an administrative task exists in SEC guidance applied under legacy US GAAP and refers to activities that do not represent discrete earnings events – i.e. selling a membership, signing a contract, enrolling a customer, activating telecommunications services or providing initial set-up services. That SEC guidance distinguishes between deliverables and these activities. It states that activities that do not represent discrete earnings events are typically negotiated in conjunction with the pricing of the deliverables to the contract, and that the customer generally views these non-deliverable activities as having significantly lower or no value separate from the entity's overall performance under the contract.

In general, entities are unlikely to reach a substantially different conclusion under the new standard when they attempt to identify administrative tasks or set-up activities from the conclusion reached under the SEC guidance related to identifying activities that do not represent discrete earnings events.

Promised goods or services that are 'immaterial in the context of the contract'

Legacy US GAAP provided that, in limited circumstances, revenue for a unit of accounting could be recognized in its entirety even if the entity had a remaining obligation, provided that remaining obligation was inconsequential or perfunctory. An undelivered item was not inconsequential or perfunctory if it was essential to the functionality of the delivered goods or services. Also, activities were not inconsequential or perfunctory if the failure to complete the activities would result in a full or partial refund or the customer's right to reject the delivered goods or services.

The assessment of whether a promised good or service is 'immaterial in the context of the contract' includes both qualitative and quantitative factors, including consideration of what may be important to the customer. Therefore, we believe application of the 'immaterial in the context of the contract' guidance may be similar to the legacy US GAAP guidance on inconsequential or perfunctory deliverables.

Determine which promised goods or services are performance obligations

Excerpt from ASC 606-10

>> Distinct Goods or Services

25-19 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).
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 promise to transfer the good or service is distinct within the context of the contract).

25-20 A customer can benefit from a good or service in accordance with paragraph 606-10-25-19(a) if the good or service could be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

25-21 In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 606-10-25-19(b), 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. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

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.

25-22 If a promised good or service is not distinct, an entity shall 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**.

Excerpt from ASC 606-10

>>> Example 10—Goods and Services Are Not Distinct

>>>> Case C—Combined Item

55-140D An entity grants a customer a three-year term license to anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The entity frequently provides updates that are critical to the continued utility of the software. Without the updates, the customer's ability to benefit from the software would decline significantly during the three-year arrangement.

55-140E The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer), while the customer can benefit from the updates together with the software license transferred at the outset of the contract.

55-140F The entity concludes that its promises to transfer the software license and to provide the updates, when-and-if available, are not separately identifiable (in accordance with paragraph 606-10-25-19(b)) because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The updates significantly modify the functionality of the software (that is, they permit the software to protect the customer from a significant number of additional viruses that the software did not protect against previously) and are integral to maintaining the utility of the software license to the customer. Consequently, the license and updates fulfill a single promise to the customer in the contract (a promise to provide protection from computer viruses for three years). Therefore, in this Example, the entity accounts for the software license and the when-and-if available updates as a single performance obligation. In accordance with paragraph 606-10-25-33, the entity concludes that the nature of the combined good or service it promised to transfer to the customer in this Example is computer virus protection for three years. The entity considers the nature of the combined good or service (that is, to provide anti-virus protection for three years) in determining whether the performance obligation is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and in determining the appropriate method for measuring progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37.

>>> Example 11—Determining Whether Goods or Services Are Distinct

>>>> Case A—Distinct Goods or Services

55-141 An entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, installation service, and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

55-142 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. The customer can benefit from the updates together with the software license transferred at the outset of the contract. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 606-10-25-19(a) is met.

55-143 The entity also considers the principle and the factors in paragraph 606-10-25-21 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus, the criterion in paragraph 606-10-25-19(b) is met). In reaching this determination the entity considers that although it integrates the software into the customer's system, the installation services do not significantly affect the customer's ability to use and benefit from the software license because the installation services are routine and can be obtained from alternate providers. The software updates do not significantly affect the customer's ability to use and benefit from the software license because, in contrast with Example 10 (Case C), the software updates in this contract are not necessary to ensure that the software maintains a high level of utility to the customer during the license period. The entity further observes that none of the promised goods or services significantly modify or customize one another and the entity is not providing a significant service of integrating the software and the services into a combined output. Lastly, the entity concludes that the software and the services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the initial software license independent from its promise to subsequently provide the installation service, software updates, or technical support.

55-144 On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

a. The software license
b. An installation service
c. Software updates
d. Technical support.

55-145 The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each of the performance obligations for the installation service, software updates, and technical support are satisfied at a point in time or over time. The entity also assesses the nature of the entity's promise to transfer the software license in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A (see Example 54 in paragraphs 606-10-55-362 through 55-363B).

>>>> Case B—Significant Customization

55-146 The promised goods and services are the same as in Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customized to add significant new functionality to enable the software to interface with other customized software applications used by the customer. The customized installation service can be provided by other entities.

55-147 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity first assesses whether the criterion in paragraph 606-10-25-19(a) has been met. For the same reasons as in Case A, the entity determines that the software license, installation, software updates, and technical support each meet that criterion. The entity next assesses whether the criterion in paragraph 606-10-25-19(b) has been met by evaluating the principle and the factors in paragraph 606-10-25-21. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) specified in the contract (see paragraph 606-10-25-21(a)). The software is significantly modified and customized by the service (see paragraph 606-10-25-21(b)). Consequently, the entity determines that the promise to transfer the license is not separately identifiable from the customized installation service and, therefore, the criterion in paragraph 606-10-25-19(b) is not met. Thus, the software license and the customized installation service are not distinct.

55-148 On the basis of the same analysis as in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

55-149 On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a. Software customization (which is comprised of the license to the software and the customized installation service)
b. Software updates
c. Technical support.

55-150 The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to measure progress toward complete satisfaction of those performance obligations determined to be satisfied over time. In applying those paragraphs to the software customization, the entity considers that the customized software to which the customer will have rights is functional intellectual property and that the functionality of that software will not change during the license period as a result of activities that do not transfer a good or service to the customer. Therefore, the entity is providing a right to use the customized software. Consequently, the software customization performance obligation is completely satisfied upon completion of the customized installation service. The entity considers the other specific facts and circumstances of the contract in the context of the guidance in paragraphs 606-10-25-23 through 25-30 in determining whether it should recognize revenue related to the single software customization performance obligation as it performs the customized installation service or at the point in time the customized software is transferred to the customer.

>>> Example 55—License of Intellectual Property

55-364 An entity enters into a contract with a customer to license (for a period of three years) intellectual property related to the design and production processes for a good. The contract also specifies that the customer will obtain any updates to that intellectual property for new designs or production processes that may be developed by the entity. The updates are integral to the customer's ability to derive benefit from the license during the license period because the intellectual property is used in an industry in which technologies change rapidly.

55-365 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer can benefit from (a) the license on its own without the updates and (b) the updates together with the initial license. Although the benefit the customer can derive from the license on its own (that is, without the updates) is limited because the updates are integral to the customer's ability to continue to use the intellectual property in an industry in which technologies change rapidly, the license can be used in a way that generates some economic benefits. Therefore, the criterion in paragraph 606-10-25-19(a) is met for the license and the updates.

55-365A The fact that the benefit the customer can derive from the license on its own (that is, without the updates) is limited (because the updates are integral to the customer's ability to continue to use the license in the rapidly changing technological environment) also is considered in assessing whether the criterion in paragraph 606-10-25-19(b) is met. Because the benefit that the customer could obtain from the license over the three-year term without the updates would be significantly limited, the entity's promises to grant the license and to provide the expected updates are, in effect, inputs that, together fulfill a single promise to deliver a combined item to the customer. That is, the nature of the entity's promise in the contract is to provide ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. The promises within that combined item (that is, to grant the license and to provide when-and-if available updates) are therefore not separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b).

55-366 The nature of the combined good or service that the entity promised to transfer to the customer is ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. Based on this conclusion, the entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to determine the appropriate method for measuring progress toward complete satisfaction of the performance obligation. The entity concludes that because the customer simultaneously receives and consumes the benefits of the entity's performance as it occurs, the performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) and that a time-based input measure of progress is appropriate because the entity expects, on the basis of its relevant history with similar contracts, to expend efforts to develop and transfer updates to the customer on a generally even basis throughout the three-year term.

After an entity has identified the 'promised goods and services' in the contract, the entity then determines which such goods or services (either individually or in combination with others) are 'performance obligations'. The 'performance obligation' is the 'unit of account' under Topic 606 – that is, an entity does not account for the promised goods or services in the contract, it accounts for the performance obligations.

A 'performance obligation' is either:

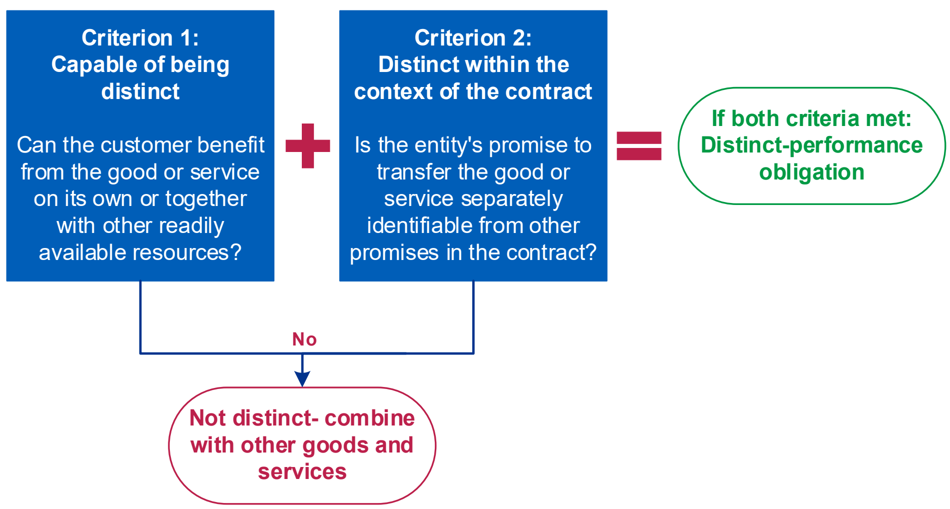
- a promised good or service (or bundle of promised goods or services) that is distinct; or
- a series of distinct goods or services that are substantially the same and meet both of the following criteria:
  - Each distinct good or service in the series that the entity promises to transfer to the customer would be a performance obligation satisfied over time (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*).
  - 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 (see

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

If a promised good or service is *not* distinct, it must be combined with another distinct good or service (or distinct bundle of goods or services). Consequently, even if a promised good or service is distinct, it may not be a separate performance obligation if one or more other promised goods or services is (are) not distinct. For example, if in a contract with a customer, Product A is determined to be distinct, but Service B is not distinct and those are the only two promised goods and services in the contract, Product A and Service B would be accounted for as a single performance obligation.

Assessing whether a promised good or service (or bundle of promised goods or services) is distinct

A promised good or service is distinct if *both* of the following criteria are met:



Good or service is capable of being distinct

A customer can benefit from a good or service if it can be used, consumed, sold for an amount that is greater than scrap value or otherwise held in a way that generates economic benefits.

A customer can benefit from a good or service on its own (i.e. it can be used, consumed, sold for an amount other than scrap value or otherwise held in a way that generates economic benefits) or in conjunction with either:

— other readily available resources that are either sold separately:
  – by the entity, which includes services only sold separately in renewal periods – e.g. post-contract customer support (PCS) that is always sold initially with a software license, but sold separately in renewal periods; or SaaS that is always sold initially together with implementation services, but sold separately to existing customers in renewal periods; or
  – by another entity;

— resources that the customer has already obtained from the entity – e.g. a good or service delivered upfront, such as a software license transferred upfront – or from other transactions or events.

The assessment of whether the customer can benefit from the goods or services on its own should be based on the characteristics of the goods or services themselves instead of the way in which the customer may use the goods or services, and the fact that a good or service is regularly sold separately by the entity is a strong indicator that the customer can benefit from a good or service on its own or with other readily available resources.

Contractual restrictions affecting either the customer's ability to derive benefit from the good or service on its own (e.g. a restriction on use or resale of a good) or the customer's ability to access a readily available resource (e.g. a prohibition against the customer obtaining implementation from an available alternative provider) would not affect the entity's evaluation of whether the good or service is capable of being distinct – that is, the evaluation ignores the contractual restriction. Importantly, this is also the case when considering the second distinct criterion (i.e. whether the entity's promises to the customer in the contract are separately identifiable).

The entity's promises to transfer the goods or services in the contract are 'separately identifiable'

The objective when assessing whether an entity's promises to transfer goods or services are separately identifiable (i.e. distinct within the context of the contract) is to determine whether the nature of the entity's overall promise to the customer is to transfer each of those promised goods or services individually or, instead, to transfer a combined item (or items) to which the promised goods or services are inputs.

Topic 606 provides the following indicators that two or more promises to transfer goods or services to a customer are not separately identifiable.

— 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. This occurs when the entity is using the goods or services as inputs to produce or deliver the output or outputs specified by the customer. A combined output (or outputs) might include more than one phase, element or unit.

— One or more of the goods or services significantly modifies or customizes, or is significantly modified or customized by, one or more of the other goods or services promised in the contract.

— The goods or services are highly interdependent or highly interrelated, such that *each* of the goods or services is significantly affected by one or more of the other goods or services. 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.

The indicators are not an exhaustive list and are not intended to be evaluated as *criteria* or to be considered in isolation from the principle that they support.

Entities should evaluate whether the nature of the entity's promise to the customer within the context of the contract is to transfer (a) multiple goods or services (i.e. multiple outputs) or (b) a combined item that is *comprised of* the multiple promised goods or services in the contract (i.e. the individual promised goods or services are inputs to the combined item). The indicators will be more or less relevant to the evaluation depending on the nature of the contract, and entities will likely attach more or less importance to a particular indicator depending on the facts and circumstances (e.g. the first indicator may provide more persuasive evidence in one contract, while the second or third provides more persuasive evidence in another contract).

The Basis for Conclusions to ASU 2016-10 expands on the Board's intent and on the application of the separately identifiable principle. BC29 explains that an entity's promises to transfer two or more promised goods or services are not separately identifiable when they will be used to create a combined item (or items) that is more than, or different from, merely the aggregate (i.e. the sum) of those component goods or services. BC32 further articulates that this refers to *each* of the goods or services significantly affecting the other; two goods or services should not be combined into a single performance obligation solely because one good or service significantly affects, or depends upon, the other (e.g. the fact that a maintenance or an installation service depends on the entity transferring the equipment or the licensed software that will be maintained or installed does not mean the entity's promises to transfer the equipment or the license and to provide the services are not separately identifiable).

Stated another way, we believe that the separately identifiable evaluation hinges on whether the promised goods or services have a 'transformative' relationship on each other, rather than merely an 'additive' relationship to each other.

Consistent with the discussion of 'capable of being distinct', Topic 606 provides that the evaluation of whether an entity's promises to transfer two or more goods or services are separately identifiable looks at the nature of the goods or services; contractual restrictions or requirements (e.g. to use the entity's services rather than an alternative provider's services) do not affect the separately identifiable evaluation.

Comparison to legacy US GAAP

The general legacy US GAAP separation model – applicable to software-as-a-service, hardware and related deliverables – focused on the separability of the delivered item (i.e. whether the delivered item had stand-alone value or a general right of return existed relative to the delivered item) and did not require an analysis of the remaining deliverables (e.g. whether the undelivered item(s) had stand-alone value) at the time the delivered item was transferred to the customer. If a delivered item in a contract with two deliverables met the separation criteria, the remaining deliverable was accounted for separately without evaluation of whether it met the separation criteria. If the contract contained more than two deliverables, an evaluation of each item's separability occurred only when that item was delivered, without consideration of the remaining undelivered items. In addition, the legacy guidance that prohibited allocating contingent revenue to a delivered item, in most cases, had the practical effect of allocating no revenue to a delivered item that had stand-alone value (i.e. negating the effect of any separation conclusion).

Meanwhile, the legacy US GAAP separation model applicable to software and software-related elements focused on the undelivered item(s) – i.e. a delivered software license was only separable if the entity had vendor-specific objective evidence of fair value (VSOE) for all of the undelivered items in the arrangement (e.g. PCS, professional services, hosting services) and any professional services in the arrangement were not essential to the functionality of the delivered software.

Under Topic 606, all goods and services are required to either be distinct (i.e. capable of being distinct and distinct within the context of the contract), and therefore separate (unless the distinct goods or services meet the series criteria), or grouped into bundles of goods and services that are distinct from the remaining goods or services in the arrangement. The requirement to establish that all of the promised goods or services in the contract are distinct or to group them into distinct bundles may have an effect, as compared to legacy US GAAP, on whether goods or services qualify for separate accounting since separation depends on the characteristics of all the promised goods or services in the contract rather than solely upon the characteristics of the item that has been delivered in a non-software arrangement or upon the undelivered items in a software licensing arrangement. For example, whether a software license to Product A is distinct now depends on its characteristics as well as those of any bundled services that are undelivered at the point in time the software license is transferred to the customer, and whether SaaS Offering B is distinct depends not only on its characteristics but also on those of the other goods or services in the contract (e.g. whether Product B and Service C are also distinct, either individually or as a bundle).

Topic 606 does not contain a contingent revenue 'cap'. Therefore, separation of goods or services under Topic 606 is not affected by such provisions in the manner it could be under legacy US GAAP. With the elimination of the contingent revenue 'cap' and the VSOE requirement for software arrangements, Topic 606 could lead to more performance obligations (or units of account) than was the case under legacy US GAAP.

Capable of being distinct

The 'capable of being distinct' criterion is similar, but not identical, to the stand-alone value criterion required under legacy US GAAP. Specifically, under legacy US GAAP, a delivered item had value on a stand-alone basis if it was sold separately by any entity or if the customer could resell the delivered item on a stand-alone basis (even in a hypothetical market).

Under Topic 606, an entity evaluates whether the customer can benefit from the good or service on its own or together with other readily available resources. This evaluation no longer depends entirely on whether the entity or another entity sells an identical or largely interchangeable good or service separately, or whether the delivered item can be resold by the customer. Rather, whether the good or service is sold separately by the entity or another entity or could be resold for more than scrap value are factors to consider in evaluating whether the customer can benefit from the good or service on its own. Factors beyond how the good or service is sold in the marketplace by the entity or others, such as the stand-alone functional utility of the product or service, are also considered in this evaluation.

Therefore, more promised goods and services may meet the capable of being distinct criterion than meet the stand-alone value criterion in legacy US GAAP. However, those goods or services must still meet the second, 'separately identifiable' criterion in order to be distinct.

'Separately identifiable' vs 'Essential to the functionality'

Under Topic 606, an entity's consideration of whether its promises to transfer a software license and provide services are separately identifiable considers whether the nature of the arrangement is for the entity to provide the software license and services, or instead, to transfer a combined item (e.g. a customized software application) that uses the software license and the entity's services as inputs to produce that combined item. Topic 606 states that the following should be considered in making that determination (not all-inclusive, entities should consider the overall principle):

— whether the entity is providing a significant integration service – that is, to combine the promised goods and services (the inputs) into the combined item (the output) for the customer;

— whether the services significantly modify or customize the licensed software; or

— whether the software license and the services are highly dependent on, or highly interrelated with, each other such that each significantly affects the other in the contract.

In contrast, when determining whether a software license and services promised in a contract with a customer should be accounted for separately under legacy US GAAP, an entity considered whether the service element is essential to the functionality of the other elements in the arrangement, including the software license. However, legacy US GAAP considered additional factors, inherent to its risks and rewards model, in determining whether software and related services should be considered a single unit of account. We do not believe these additional factors would affect the question of separation under Topic 606. These factors included whether:

— the timing of payments for the software was coincident with performance of the services;
— milestones or customer-specific acceptance criteria affecting the realizability of the software-license fee;
— the services carried a significant degree of risk or unique acceptance criteria;
— the entity was an experienced provider of the services.

In many circumstances, entities will come to similar separation conclusions under Topic 606 as under legacy US GAAP; however, the conclusions reached between 'separately identifiable' and 'essential to the functionality' may not always be the same. For example, some entities may conclude that a software license and services should be combined under Topic 606 (i.e. because they are not separately identifiable) even though the services are not currently considered essential to the software's functionality. The converse is also possible.

Effect of contractual restrictions/limitations

An SEC staff speech from 2009 (Arie S. Wilgenburg speech at the 2009 AICPA National Conference on Current SEC and PCAOB Developments) stated that, generally, separability of deliverables in a revenue arrangement should be evaluated on the basis of the inherent nature of those deliverables, rather than on specific restrictions in the contract.

Topic 606 similarly looks to the inherent nature/characteristics of the goods or services in evaluating whether a good or service is capable of being distinct and whether an entity's promises to transfer two or more goods or services are separately identifiable. Contractual restrictions, therefore, do not affect those evaluations.

VSOE no longer affects separability in software licensing arrangements

Under legacy US GAAP software revenue recognition guidance, a delivered item (e.g. a software license delivered upfront) was only accounted for as a separate element of the arrangement if the software entity had VSOE for the undelivered elements (e.g. PCS, professional services, hosting services, or any specified update or specified additional software product). If the entity did not have VSOE for all undelivered items, the delivered item (typically a software license) was combined with the undelivered items and the revenue attributable to those items was generally recognized either over the service period (e.g. in the case of PCS or professional services) or at the point in time the undelivered item was delivered (e.g. when a specified upgrade was delivered).

In contrast, under Topic 606, the presence or absence of VSOE has no effect on whether two promised goods or services in a software licensing arrangement are separate performance obligations. Because VSOE was often difficult to establish under legacy US GAAP, the elimination of the VSOE requirement for separation will generally result in more items in software licensing arrangements being accounted for as separate performance obligations than are accounted for as separate elements under the legacy guidance.

A series of distinct goods or services

Excerpt from ASC 606-10

> Identifying Performance Obligations

25-14 At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:

a. A good or service (or a bundle of goods or services) that is distinct
b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 606-10-25-15).

25-15 A series of distinct goods or services has the same pattern of transfer to the customer 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 would meet the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time.
b. In accordance with paragraphs 606-10-25-31 through 25-32, 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.

>>> Example 12A—Series of Distinct Goods or Services

55-157B An entity, a hotel manager, enters into a contract with a customer to manage a customer-owned property for 20 years. The entity receives consideration monthly that is equal to 1 percent of the revenue from the customer-owned property.

55-157C The entity evaluates the nature of its promise to the customer in this contract and determines that its promise is to provide a hotel management service. The service comprises various activities that may vary each day (for example, cleaning services, reservation services, and property maintenance). However, those tasks are activities to fulfill the hotel management service and are not separate promises in the contract. The entity determines that each increment of the promised service (for example, each day of the management service) is distinct in accordance with paragraph 606-10-25-19. This is because the customer can benefit from each increment of service on its own (that is, it is capable of being distinct) and each increment of service is separately identifiable because no day of service significantly modifies or customizes another and no day of service significantly affects either the entity's ability to fulfill another day of service or the benefit to the customer of another day of service.

55-157D The entity also evaluates whether it is providing a series of distinct goods or services in accordance with paragraphs 606-10-25-14 through 25-15. First, the entity determines that the services provided each day are substantially the same. This is because the nature of the entity's promise is the same each day and the entity is providing the same overall management service each day (although the underlying tasks or activities the entity performs to provide that service may vary from day to day). The entity then determines that the services have the same pattern of transfer to the customer because both criteria in paragraph 606-10-25-15 are met. The entity determines that the criterion in paragraph 606-10-25-15(a) is met because each distinct service meets the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time. The customer simultaneously receives and consumes the benefits provided by the entity as it performs. The entity determines that the criterion in paragraph 606-10-25-15(b) also is met because the same measure of progress (in this case, a time-based output method) would be used to measure the entity's progress toward satisfying its promise to provide the hotel management service each day.

55-157E After determining that the entity is providing a series of distinct daily hotel management services over the 20-year management period, the entity next determines the transaction price. The entity determines that the entire amount of the consideration is variable consideration. The entity considers whether the variable consideration may be allocated to one or more, but not all, of the distinct days of service in the series in accordance with paragraph 606-10-32-39(b). The entity evaluates the criteria in paragraph 606-10-32-40 and determines that the terms of the variable consideration relate specifically to the entity's efforts to transfer each distinct daily service and that allocation of the variable consideration earned based on the activities performed by the entity each day to the distinct day in which those activities are performed is consistent with the overall allocation objective. Therefore, as each distinct daily service is completed, the variable consideration allocated to that period may be recognized, subject to the constraint on variable consideration.

A contract may contain a promise to transfer a series of distinct goods or services that are substantially the same. For example, a two-year services contract may consist of 24 monthly (or even 730 daily) service periods during which the entity is providing the same service to the customer. At contract inception, an entity assesses the goods or services promised in the contract and determines whether there is a series of goods or services that is a single performance obligation. This is the case when they meet the following criteria.

The goods or services are substantially the same	**+**	**Each distinct good or service in the series is a performance obligation satisfied over time (see Chapter F)**	**+**	**The same method would be used to measure progress toward satisfaction of each distinct good or service in the series (see Chapter F)**	**=**	**A single performance obligation**

Accounting for a series of distinct goods or services that meet the criteria as a single performance obligation is not optional. If the series requirements are met for a group of goods or services, then those items are treated as a single performance obligation. Further, an entity is not permitted to account for a single performance obligation comprising a series of distinct goods or services in the same manner as a single performance obligation that comprises nondistinct goods or services. For example, as noted below, variable consideration could be allocated differently depending on whether the single performance obligation is a series or not a series.

The criteria to determine whether the series guidance applies does not require an assessment of the amount or timing of revenue that would have been recognized in a period with or without the application of the series guidance. [606-10-25-15, TRG Agenda Paper No. 27]

The series guidance was included in Topic 606 to simplify application of the revenue model and to promote consistency in identifying performance obligations. In particular, without this guidance some repetitive service contracts may have been separated into multiple performance obligations (e.g. delivering electricity or transaction processing). This would require an entity to allocate consideration to each increment of service. For example, without the series guidance, an entity may need to allocate consideration to each hour or day of service in a cleaning service contract. [ASU 2014-09.BC114]

Determining the nature of the entity's promise to the customer is the first step in applying the series guidance

Determining the nature of the entity's promise to the customer is the first step in determining whether the series guidance applies. For example, if the nature of the promise is the delivery of a specified quantity of a good or service, then the evaluation should consider whether each good or service is distinct and substantially the same.

Conversely, if the nature of the entity's promise is to stand-ready or to provide a single service for a period of time (i.e. there is not a specified quantity of activities to be performed, such as in the hotel management scenario illustrated in Example 12A of Topic 606 – paragraphs 606-10-55-157B – 55-157E), then the evaluation will typically focus on whether each time increment, rather than the underlying fulfillment activities, is distinct and substantially the same. For example, a three-year SaaS arrangement providing unlimited access (or a defined quantity that is not substantive – e.g. because the customer is unlikely to surpass the defined limit) will typically be viewed as a series of distinct service periods (e.g. each day, week or month of the three-year arrangement) that provide substantially the same service (i.e. continuous access to the entity's hosted application) each period. It will generally not be important that the entity might undertake different activities with respect to the hosted application or maintaining its data center each of those distinct service periods, or that the customer may use the hosted application differently or in different amounts each of those periods.

The TRG agreed that when the nature of the promise is to stand ready or provide a single service for a period of time, the underlying activities could vary significantly from day to day but the nature of the promise does not change from day to day. The TRG specifically discussed arrangements such as hotel management, transaction processing and IT outsourcing which had integrated activities that formed a single performance obligation of which the nature of the promise was a single service to the customer each day.

For example, in the hotel management service the activities required to fulfill the contract could include management of the different hotel functions such as training, procurement, reservations, etc. In that example, the underlying activities could vary significantly within a day and from day to day; however, the promise to the customer to manage the hotel is the same each day. [TRG Agenda Paper No. 39]

Certain software-related services will also typically be a series of distinct service periods. For example, technical support services and rights to unspecified updates, upgrades and/or enhancements will typically constitute either a series of distinct *service periods* (if those are determined to be 'stand-ready obligations' – see Question C130) or a series of distinct individual *services* (if not a 'stand-ready obligation'). Hosting services provided with respect to licensed software will also generally constitute a series of distinct service periods.

Not necessary for goods or services to be provided consecutively

To apply the series guidance, it is not necessary that the goods be delivered or services performed consecutively over the contract period. There may be a gap or an overlap in delivery or performance *when the overall nature of the entity's promise is not a 'stand-ready obligation'* (e.g. there will be gaps between technical support calls or the provision of software updates), and this would not affect the assessment of whether the series guidance applies. Although the Boards specifically contemplated a consecutively delivered contract (e.g. a repetitive service arrangement), they did not make this distinction a criterion for applying the series guidance. [TRG Agenda Paper No. 27]

Identifying distinct goods or services as a series may affect the allocation of variable consideration and the accounting for contract modifications

Effect on variable consideration. Identifying a service obligation (such as a SaaS arrangement) as a series of distinct service periods can significantly affect the accounting for variable consideration in the contract. This is because, in such cases, Topic 606 permits entities, if the criteria in paragraph 606-10-32-40 are also met (discussed in detail in *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*), to allocate variable consideration entirely to distinct service periods (e.g. each day, month, quarter or year) within a single, series performance obligation – i.e. rather than to the performance obligation as a whole. Therefore, if the consideration for a service (e.g. a SaaS obligation) varies based on discrete activities in each distinct service period (e.g. based on the customer's use of the SaaS platform), the entity may be able to allocate all of the variable fees attributable to those activities to that distinct service period. In the absence of a conclusion that the single service performance obligation is a series of distinct service periods *and* meeting the variable consideration allocation criteria in paragraphs 606-10-32-39 through 32-40, entities will generally be required to estimate such fees for the entire performance obligation period and true-up that estimate, as well as revenue recognized to-date for the performance obligation as a whole, throughout the overall service period (e.g. the three-year SaaS contract period).

Effect on contract modifications. A conclusion that a service obligation is a series of distinct service periods, which will typically be the case for stand-ready obligations, can also significantly affect the accounting for contract modifications. This is because the contract modifications accounting model in Topic 606 differs depending on whether the remaining goods or services to be provided after a contract modification are or are not distinct from the goods or services provided before the modification (rather than on whether they are separate performance obligations). Consequently, the accounting for a modification to a SaaS arrangement, or to a software licensing arrangement that includes PCS or hosting services, will differ depending on whether the entity concludes that the SaaS, or the PCS or hosting services, is a series of distinct service periods (i.e. such that each period subsequent to the modification is distinct from those preceding it).

Chapter G – Contract modifications provides further guidance on contract modifications.

Questions & answers

Question C5

Does an entity apply the practical expedient for immaterial goods or services on a contract-by-contract basis?

Interpretive response: No, we believe entities should apply the practical expedient to immaterial goods or services consistently to similar promises in similar contracts.

Example C5.1

Goods or services immaterial in the context of the contract – qualitative assessment

Software entity enters into a contract to provide Customer with software and PCS. The contract also provides Customer with the right to receive up to 20 hours of training services on how to operate the software at no additional cost.

In evaluating the promises in the contract, Software entity determines that although the promised training hours are not quantitatively significant, they are not considered immaterial in the context of the contract for the following reasons.

— The training services will allow Customer to optimize the software within a short period of time.
— Customer's ability to optimize the software it is procuring is likely important to Customer.

Therefore, Software entity considers the software, PCS and training services as promises in the arrangement. Software entity further assesses whether those promises are distinct from one another and if so, accounts for them as separate performance obligations. [606-10-55-309]

Question C10

Do restrictions as to time, geography and/or use affect how many software licenses are promised to the customer in the contract?

Interpretive response: It depends. Software licenses frequently include restrictions as to time, geography and/or use of the software. For example, a license may be for a period of time that is less than the economic life of the software, for use only within one or more specified geographies (e.g. within the United States or North America only), and/or may only permit specified uses of the software (e.g. for use only in a specified class of product).

In most cases, restrictions on a software license are attributes of the bundle of rights that make up the license and do not create additional promises to transfer licenses to the customer. However, in some cases, a restriction is substantively a promise by the entity to grant *additional* rights to use the entity's software (i.e. one or more additional licenses) to the customer at a point in time later than when the customer obtains control of an 'initial' license (i.e. initial rights to use the entity's software). The distinction arises because:

— a license is the contractual right to use (or right to access) IP, and not the IP itself; and

— the FASB decided that a customer does not control a license until it can begin to use and benefit from the rights conveyed by that license, even if a copy of the IP (e.g. the licensed software) has been provided – see Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

Therefore, it is not sufficient that an entity has delivered a copy of the licensed software and the customer can begin to use and benefit from some rights to use that software. If the entity has promised to grant additional rights to use that software in the future (as illustrated in Scenario 2 of Example C10.1), the entity still has one or more additional promises to fulfill. The fact that the entity may not have to deliver any additional software to fulfill the additional promises does not affect this conclusion.

Example C10.1
License restrictions

Scenario 1: Restrictions do not create an additional promise to the customer

ABC Corp. grants Customer a three-year term license to use its software beginning on January 1, 20X6. The terms of the license only permit Customer to have 10 named users, to load the software on servers maintained in the United States (for protective reasons related to the entity's intellectual property (IP)) and to use the software in the development of a particular class of product (video game development). ABC makes available to Customer a copy of the software and Customer's rights to use the software commence on January 1, 20X6.

Even though there are restrictions on this license (i.e. it is not perpetual, worldwide or unlimited as to permitted uses of the software), those restrictions represent attributes of a single license that is transferred to the customer on January 1, 20X6 (January 1, 20X6 being the date that the customer can begin to use and benefit from the rights granted). After the entity transfers control of the license to the customer on January 1, there are no additional promised rights remaining to be transferred – e.g. rights for the customer to use the software in additional geographies or for additional uses, or to permit additional named users to use the software. The customer controls all of the rights to use ABC's software that it will ever control under the contract as of that date.

Scenario 2: Restrictions are indicative of an additional promise to the customer

In addition to the rights granted to Customer in Scenario 1, assume the contract also provides that, beginning on January 1, 20X7 (i.e. one year after Customer obtains controls of the rights granted in Scenario 1), either Customer is permitted:

- 20 named users (an increase from 10 named users permitted as of January 1, 20X6); or
- to begin to use the software for the development of products in the field of consumer robotics (i.e. a different application from video game development).

In either case, ABC must grant additional rights to use its software on January 1, 20X7 that Customer does not control before that date (i.e. from January 1, 20X6 through December 31, 20X6).

Consequently, at contract inception, ABC has two promises to fulfill to Customer:

- a promise to transfer a software license comprising the rights and attributes described in Scenario 1 on January 1, 20X6; and
- a second promise to transfer an additional license, comprising additional rights to use ABC's software (i.e. 10 additional users or additional use rights), on January 1, 20X7.

Comparison to legacy US GAAP

The explicit distinction Topic 606 draws between the delivery of software and the transfer of the rights to use the delivered software may appear new to some that have not previously considered the right to use software separately from the software itself. However, this notion that incremental rights to use previously delivered software constitute an additional deliverable existed in the legacy US GAAP software guidance on concessions (paragraphs 985-605-55-18 through 55-21). That guidance identified extending the geographic area in which a reseller is allowed to sell the software, or the number of locations in which an end user can use the software without commensurate additional consideration as examples of a concession to a customer involving additional deliverables.

Question C15

Are promises to defend a patent, copyright or trademark an administrative activity or a promised good or service?

Interpretive response: An entity's promise to defend its patent, copyright or trademark is an administrative activity, not a promised good or service, because it does not transfer goods or services to the customer. These types of activities do not benefit the customer beyond the access to the good or service provided in the contract and relate to the entity's own assets. [606-10-55-64A]

In contrast, if an entity enters into a contract with a customer that is a named defendant in a patent infringement lawsuit and agrees to provide legal support to the customer rather than promising to defend its own patent, the entity may be providing a legal service to the customer.

Question C16

Is an exclusivity provision a promised good or service?

Interpretive response: Generally, no. Entities may enter into contracts with customers that provide the customer with the exclusive right to the entity's goods or services, restrict the entity's ability to sell its goods or services to other customers or geographies, or both. For example, an entity might enter into a software licensing contract with a distributor and agree not to sell its products to the customer's competitors or to provide the distributor the benefit of being an 'authorized dealer' to use the entity's trademarks in conjunction with the sale of branded software licenses purchased from the entity.

The FASB discussed exclusivity clauses in the context of licenses of IP and noted that exclusivity is another restriction that represents an attribute rather than the nature of the underlying IP or the entity's promise in granting a license. Therefore, an entity does not separately account for exclusivity in a license arrangement and the exclusivity does not affect whether that license is transferred at a point in time or over time. [ASU 2014-09.BC412(b)]

Based on the above, we generally believe exclusivity is an attribute of the promise to the customer rather than a promised good or service itself as it does not change the nature of the underlying promise to the customer, which is to provide the goods or services. Exclusivity may affect the value of or price for the underlying good or service. However, the promised good or service is typically what the customer will have the right to obtain or use.

In some cases, a customer may make a payment for the exclusivity or an upfront payment upon entering into the exclusive arrangement. In that case, the entity will need to evaluate whether the payment indicates that contract includes a material right. A material right might be present if the contract provides the customer with options to purchase additional goods or services during the exclusivity period. If no material right is present, the payment would be a part of the transaction price. See Question C410 and Question D20 on evaluating upfront payments received from customers.

In some cases, the entity may pay the customer to enter into an exclusive relationship. In that case, an entity will need to evaluate whether the payment is for a distinct good or service or whether it should be accounted for as a reduction of revenue. Similarly, an entity will need to evaluate whether the payment meets the definition of an asset and should be capitalized and amortized. See Question D370 on upfront payments to customers.

Question C20

Are remix rights in a software contract an additional promised good or service to the customer?

Remix rights

Software arrangements may allow a user to change or alternate its use of multiple products/licenses (license mix) included in a license arrangement. The user has obtained the right under the arrangement to deploy and use at least one copy of each licensed product – i.e. the user has a license to use each delivered product and solely controls whether to change its license mix. The products may or may not be similar in functionality.

These arrangements may allow the customer to use at any time any mix or combination of the products provided the cumulative value of all products in use does not exceed the total license fee. Certain of these arrangements may not limit usage of a product or products, but instead may limit the number of users that simultaneously can use the products (concurrent user pricing).

Interpretive response: No. The right to remix software licenses is *not* an additional promised good or service. In contracts that include remix rights (which are separate from any rights conveyed in the contract to specified or unspecified future additional software products), the software subject to those rights is delivered upfront and the customer has control over its rights to use that software (e.g. number of seats or users and software products deployed). Remix rights are, therefore, an *attribute* of the rights that the customer already controls. There is no obligation left to fulfill on the part of the software entity once the software subject to the remix rights is provided and the customer can begin to use and benefit from its rights under the licenses.

Remix rights do not include the ability to remix into *undelivered* software licenses (e.g. a software product that is not yet delivered or a right the customer does not yet control, such as a right the customer will only have in the future to use one of the delivered software products for an additional purpose). For example, some remix arrangements permit the customer to remix into future software products developed during the license period. In such cases, the remix rights themselves are not an additional promised good or service, but instead there is a specified or unspecified additional software product right in the contract (see Question C320).

Remix rights are not equivalent to exchange or return rights because, when the customer remixes, no software licenses are returned *to* the entity and no new software licenses to previously undelivered software products are transferred *by* the entity.

Comparison to legacy US GAAP

Accounting for remix rights under Topic 606 is consistent with the accounting for those rights under legacy US GAAP.

Question C30

Is a contractual requirement to put the source code of a software application into escrow a performance obligation?

Interpretive response: It depends. To protect the customer in the event that a software entity ceases operations, some licensing arrangements require the entity to deliver the source code for the licensed software into an escrow account. The customer obtains access to that code only in the event that the software entity ceases operations. Those requirements are customary in software licensing arrangements.

We believe that a standard escrow requirement for the licensed software's source code is a protective right to the customer rather than an additional promised good or service in the contract, similar to other protective rights such as a promise to defend a patent right with respect to the IP (see Question C15). However, the specific terms of each contract should be evaluated, and unique provisions could result in a different conclusion.

Question C40

When does a promise to transfer multiple copies of a software product constitute a promise to transfer multiple licenses?

Interpretive response: In general, we believe that a promise to transfer multiple copies (whether characterized as users, seats or similar) of a software product constitutes a promise to transfer multiple licenses if the customer's ability to make use of (or derive benefit from) the licensed software varies in proportion to the number of copies transferred (see Example C40.1).

A further strong indicator of a multiple license arrangement is when the consideration in the contract is proportional to the number of copies transferred and is due and payable when the additional copies are transferred to the customer.

In other cases, a promise to transfer multiple copies may not be a promise to transfer multiple licenses – e.g. if the customer's ability to make use of (or derive benefit from) the software does not vary in proportion to the number of copies transferred.

If promise to transfer copies is not a promise to transfer multiple licenses

If a promise by the entity to transfer multiple copies of the licensed software is *not* a promise to transfer multiple licenses (as for Customer B in Example C40.2), it must then consider whether that promise to provide copies of the licensed software either:

1. still represents a promise to produce and deliver additional copies of the licensed software; or
2. is solely a fulfillment activity that does not transfer any additional good or service to the customer (as described in paragraph 606-10-25-17) – i.e. the activity does not provide any substantive incremental benefit to the customer.

We believe that a promise to provide additional copies of licensed software falls into category (2) only if *both*:

— the customer could make the additional copies without the entity's participation – i.e. suggesting that the production and delivery of additional copies is effectively a convenience to the customer; and

— the costs to produce and deliver the additional copies is largely nominal. A greater cost would suggest that the entity's promise to transfer the additional copies provides a service to the customer.

If either of these criteria is not met, we believe that the promise to provide additional copies of the licensed software is providing a service to the customer – i.e. it falls into category (1).

There may be circumstances in which the entity concludes that a promised service of producing and delivering additional copies is immaterial in the context of the contract. [606-10-25-16A]

Concluding that a promised good or service is immaterial in the context of the contract involves consideration of both quantitative and qualitative factors. Consequently, a promised service of providing additional copies may not be immaterial in the context of the contract, even if the cost of producing the additional copies is nominal. This will depend on the importance to the customer of those additional copies and the customer's ability to produce the copies itself. If the customer needs those copies to make effective use of the software and cannot produce those copies itself, that may suggest the entity's promised service to provide those copies is not qualitatively immaterial in the context of the contract.

Question C390 discusses a related question about whether an *option* to acquire additional copies of licensed software (including rights to additional seats, users or similar) is an option to acquire additional software licenses or a usage-based variable fee.

Site license

A site license is a license that permits a customer to use either specified or unlimited numbers of copies of a software product either, throughout the company or at a specified location. For arrangements involving site licenses, the licensing fee is payable regardless of the number of copies requested by the customer.

Multiple single license arrangements

For arrangements that involve multiple single licenses, the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller. The licensing fee is not due and payable until the copies of the software are delivered to or made by the customer.

Example C40.1
Multiple copies are multiple licenses

Assume that a single copy of software product G either enables a customer to process 100,000 transactions or operate 10 customer locations, and that five copies of product G would enable that same customer to process 500,000 transactions or operate 50 customer locations.

In this example, a customer's processing capacity (i.e. its ability to derive benefit from the use of product G) is a function of the number of copies transferred. Therefore, an arrangement to provide 5 copies would be considered a contract to transfer 5 licenses to the customer.

Example C40.2
Multiple copies are not multiple licenses

Two comparable customers (Customer A and Customer B) enter into the same licensing arrangement to use an entity's accounting software on a worldwide basis. Each customer is permitted as many copies of the software as it deems necessary.

— Customer A's accounting staff work at one central location, and therefore only one copy of the software is necessary.
— Customer B's similar number of accounting staff are distributed at several regional locations, and multiple copies of the software are required for Customer B to load on its servers at each location.

The customers' ability to use the software for their respective accounting activities is not affected by the number of copies of the software delivered to the customer. Customer A's one copy will permit Customer A to perform the same volume of accounting as Customer B's multiple copies.

In this example, the nature of the arrangement is not different (one license versus multiple licenses) solely because Customer B has made a decision, unrelated to the capabilities of the software, to have a distributed accounting function.

Comparison to legacy US GAAP

Under legacy US GAAP, entities generally categorized arrangements as either for a site license or for multiple single licenses. The key distinction was whether "the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller." If so, the arrangement was for multiple licenses rather than a site license.

The guidance in Topic 606 is not linked to the payment provisions in the contract. However, it is similar with respect to linking the single versus multiple license question to whether the customer's ability to make use of the licensed software varies in proportion to the number of copies/seats/users licensed. In practice, most multiple single license arrangements have fees that are a function of the number of copies/seats/users delivered to, made by or deployed.

Question C50

Is a promise to provide appropriate end-user documentation a promise to transfer a good to the customer?

Interpretive response: In general, no. We believe that providing end-user documentation (e.g. training manuals) is an administrative task if that documentation merely pertains to instructing the customer on how to obtain the inherent utility of the software (or SaaS). In that case, the end-user documentation does not provide incremental benefit to the customer, and therefore is not an additional promised good in the contract.

The end-user documentation might be necessary for the customer to begin to use and benefit from the software – i.e. the customer cannot make substantive use of the software without the documentation, and there are no alternative resources available that would allow the customer to make substantive use of the software (such as consultants or third-party documentation). In that case, the entity may conclude that the license has not been transferred to the customer until the documentation has been provided.

Providing *standard* end-user documentation should be distinguished from a promise to provide additional materials that would provide incremental benefit to the customer. One example is information of a consulting nature that helps the customer do more than simply achieve the core utility from the software or the SaaS.

Question C60

Is a software entity's participation in a joint steering committee (JSC) considered a promised service in a contract with a customer?

Interpretive response: It depends. JSCs are often created through collaborative R&D agreements to ensure that all the parties are working to achieve the goals of the activity. For example, an entity may license its software to another software vendor or original equipment manufacturer (OEM), and agree to provide R&D services to develop technology that will benefit sales of both parties' products. As part of this arrangement, the entity may agree to participate with the other party on a joint development steering committee.

Topic 606 explicitly excludes from its scope contracts, or portions of a contract, that are with a collaborator or partner that are not customers, but rather share with the entity the risks and benefits of developing a product to be marketed. Therefore, it is important for an entity that engages in collaborative arrangements to analyze whether the other parties in its contracts are customers – i.e. a party that has contracted with the entity to obtain goods or services that are an output of the entity's ordinary activities. For further discussion on whether an arrangement is a collaboration, see *Chapter A – Scope*.

When an entity agrees to participate in a JSC in a contract with a customer, it should evaluate the substance of the contractual provision relative to JSC participation. If participation in a JSC is required under the contract with the customer, that participation is generally an additional promised service. However, if participation in the JSC is permitted but not required, JSC participation may not be an additional promised service in the contract, but rather a right of the entity to protect its own interest in the arrangement.

The presence of any of the following factors generally indicates that participation on the JSC is a promised service in the contract, rather than solely a protective or participating right of the entity:

- participation requires specific action by the entity – e.g. specific persons with unique skills that are significant to the project or a specific time commitment;
- failure to perform would result in a substantive penalty for the entity; and/or
- the inclusion or exclusion of the JSC participation from the contract would significantly affect the other terms of the contract (e.g. the transaction price, timing of payments or customer acceptance).

Promised goods and services in a contract do not have to be explicit contractual requirements, but rather can be implied promises that a customer would reasonably expect the entity to perform based on the entity's customary business practices and policies. As such, entities may need to evaluate their customary business practices and policies with respect to JSC participation to determine whether JSC participation is implied, even if the contract is silent or where such participation is optional in accordance with the terms of the contract. [606-10-25-16]

Comparison to legacy US GAAP

In general, the accounting for JSCs is similar to legacy US GAAP.

However, both the timing of revenue recognition and allocation of the transaction price may be significantly different for contracts that include the sale or licensing of software. Legacy US GAAP required vendor specific observable evidence of fair value (VSOE) of all undelivered elements in order to separate the elements in the arrangement; this included any JSC participation that was determined to be a deliverable. If the entity did not have VSOE for its JSC participation, this often resulted in recognition of the combined arrangement fees over the JSC participation period.

Under Topic 606, if the JSC is determined to be a performance obligation, a portion of the transaction price is allocated to the JSC participation based on the relative stand-alone selling price of the JSC participation, without regard to whether VSOE exists for the JSC participation.

In addition, the relative stand-alone selling price allocation to the various performance obligations in the contract that includes JSC participation (e.g. a software license, other professional services) may differ from the allocation that would result from applying legacy US GAAP. For a discussion of allocation issues, see *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*.

Question C70

Is a customer's right to return a product or a right to a refund for services a performance obligation?

Interpretive response: Typically, no. Paragraph 606-10-55-24 states "an entity's promise to stand ready to accept product returns should not be accounted for as a performance obligation in addition to the obligation to provide a refund." Paragraph 606-10-55-23 addresses the accounting for returns and includes "transfer of products with a right of return (and some services that are provided subject to a refund)" in the scope of that guidance.

An obligation to accept product returns or to provide refunds (whether in the form of cash or credit toward future products or services) for services (including SaaS) is not a performance obligation other than as discussed in Question C80 pertaining to *certain* situations where a customer has the right to exercise a return right an unlimited number of times. Instead, rights of return or refund are treated as variable consideration, regardless of whether the customer is entitled to a cash refund as a result of the return or, instead, is only entitled to a credit toward future purchases from the entity. Therefore, estimated returns normally should be considered by the entity in determining the transaction price of the contract. [606-10-55-23 – 55-24]

Comparison to legacy US GAAP

Legacy US GAAP allowed entities to recognize the sale of products subject to a right of return when risks and rewards of ownership had passed to the customer and the amount of future returns could be reasonably estimated, among other criteria. Sales revenue (and cost of sales) that was not recognized at the time of sale – because the amount of future returns could *not* be reasonably estimated – was recognized at the earlier of the return right expiring, or the criteria related to making a reasonable estimate of returns being met.

The guidance under legacy US GAAP applied to products only, and not to services. However, SEC guidance allowed entities to analogize to the product right of return guidance with respect to services in limited circumstances.

The Topic 606 approach of adjusting revenue for the expected level of returns and recognizing a refund liability is broadly similar to the legacy guidance when the entity can make a reasonable estimate of the returns. However, the detailed methodology for estimating revenue may be different.

The Topic 606 methodology requires the use of either the expected value or most likely amount method to determine the expected returns, depending on which better predicts the consideration to which the entity will be entitled. After an estimate of expected returns is made, the entity assesses whether it is probable that using that estimate would *not* result in a significant revenue reversal and, if not, the amount of revenue to be recognized is constrained. The variable consideration constraint is designed so that most adjustments to revenue occur upward (i.e. are *increases* to revenue). Because legacy US GAAP only required future returns to be reasonably estimable, entities often recorded upward *and* downward adjustments to revenue as a result of the right of return guidance.

Although revenue could conceivably be constrained to zero under Topic 606, it is likely that most entities will have sufficient information to recognize consideration for an amount greater than zero even when they would not be able to 'reasonably estimate' returns under legacy US GAAP. This is because revenue is recognized to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized under the contract will not occur and recognition does not necessarily default to zero (as happened under legacy US GAAP when a reasonable estimate of returns could not be made). As a consequence, entities that are unable to make a reasonable estimate of returns may recognize some amount of revenue sooner under Topic 606.

Question C80

Under what circumstances is the right to exchange one or more software licenses for one or more alternative licenses considered an additional performance obligation?

Background: The question addresses a customer's right to exchange a license to one software product for a license to another software product. Question C85 addresses a customer's right to convert a software license to the same software on a SaaS basis.

Interpretive response: The determination of whether an exchange right should be accounted for as a right to obtain additional software licenses is generally based on whether the customer is contractually entitled to continue using the originally delivered software.

Customer retains the right to use the originally transferred software

If the contract permits the customer to continue using the original software license, the exchange right is accounted for as a *right* to obtain an additional software license. This is because the customer is entitled to two licenses rather than one, which should be evaluated in the same manner as any other customer option to acquire a software license (see Questions C380 to C490).

If the customer does not have to pay a fee (or only has to pay a nominal fee to obtain the additional software license – e.g. the cost of shipping a CD containing additional software, if the license is to an additional software product), or has the option to acquire the additional software license for a fee that is substantially discounted from its stand-alone selling price, then that right is a 'material right' and constitutes a performance obligation in the contract – i.e. in addition to the initial promised software license.

Customer is not entitled to continue using the originally transferred software

Right to exchange for a software license that has no more than minimal differences in price, functionality or features

Under Topic 606, rights to exchange one product for another of the same type, quality, condition and price are not considered returns or additional promised goods in the contract. Therefore, the right to exchange one software license for another that has no more than minimal differences in price, functionality or features is neither a return right nor a right to an additional software license. Therefore, it should be accounted for as a like-kind exchange, which will have no effect on the revenue recognition related to the transferred license.

A license is a right to use software; it is not the software itself. Therefore, a license does not necessarily have no more than minimal differences in price, functionality or features solely because the license the customer will receive in exchange grants the customer rights to use the same software product as the initial software license. For example, a right to exchange a limited license to software product X (e.g. limited as to geography or use) for an unlimited license or a license with substantially different limitations (e.g. different or expanded geography or use rights) also to software product X is a license with more than minimal differences in price, functionality or features.

Right to exchange for a software license that has more than minimal differences in price, functionality or features

Rights to exchange software licenses for dissimilar licenses (i.e. those with more than minimal differences in price, functionality or features) are generally accounted for as rights of return. In a situation where the license the customer can exchange into is of significantly greater value (e.g. it provides significantly more rights or is for a product with significantly more features or functionality), and the customer is not required to pay commensurate additional consideration, the right of return guidance would likely result in deferral of all (or substantially all) the initial license fee until the exchange occurs or the likelihood of the exchange becomes remote.

Topic 606 does not provide guidance about determining if two licenses have more than minimal differences in price, functionality or features; therefore, the comparison should be based on the relevant facts and circumstances on a case-by-case basis. Further, it is important to remember that the promised good in a software license arrangement is a license, and *not* the software itself. Therefore, the determination does not depend solely on whether the license being evaluated is for a different software product. A license for the same software product may be significantly different in terms of the rights it conveys to the customer.

Factors indicating that there may be more than minimal differences in price, functionality or features between two software licenses may include the following.

— The license to be received is for a software product that has a different name from the software product subject to the original license.

— Marketing materials for the software product to be licensed promote different functionality and features than the software product subject to the original license.

— The software product for which a license will be received operates outside the performance domain of the software product subject to the original license.

— In independent transactions, a license to the software product to be received is sold for a price significantly different from the original license.

— The license that will be received conveys to the customer substantive rights to use a previously delivered software product that it does not already control. For example, the license that will be received permits additional (or different) rights to use the software, such as the right to use the software in additional geographies or for additional uses.

Right to exchange for unspecified future software licenses

In general, rights to exchange software licenses for unspecified future software licenses do not qualify for like-kind exchange accounting because it is not possible to conclude that unspecified future licenses will have no more than minimal differences in price, functionality or features from the original software license. It may also be hard to conclude that an unspecified future license will not provide significantly greater value to the customer than the initial license; and therefore, may frequently result in deferral of all (or substantially all) the initial license fee until the exchange occurs or the likelihood of the exchange becomes remote.

Therefore, a right to exchange a software license for an unspecified software license is generally accounted for as a right to return the initial software license.

Right to exchange for unspecified software licenses an unlimited number of times

An unspecified software license exchange right (including a provision characterized as a right of return under which the customer only obtains a credit with which it can acquire additional software licenses from the entity) may be exercisable an unlimited number of times over a specified period. In such cases, we believe it may be appropriate for the entity to account for that right in the same manner as a right to unspecified additional software licenses (see Question C320) *provided that* the credit the customer obtains toward additional software licenses decreases over the exchange right period in a manner generally consistent with the customer's consumption of its right to use the originally licensed software.

This approach would not be appropriate if the customer can return the software license for a full credit throughout the exchange right period because that approach would result in recognition of revenue ahead of the entity's performance. Instead, the right of return guidance would apply.

It is also not appropriate under Topic 606 to account for the entire arrangement that includes a right to exchange software an unlimited number of times as a subscription, and therefore to recognize all of the arrangement revenue ratably over the exchange right period, because such an approach would result in failure to recognize revenue upon transfer of control of the initial license(s) to the customer.

Comparison to legacy US GAAP

End-user considerations

The guidance on accounting for rights to exchange one or more software licenses for one or more alternative licenses is substantially similar to that under legacy US GAAP, other than with respect to exchange rights that can be exercised an unlimited number of times over a specified period or multiple times over a significantly extended period (e.g. the entire economic life of the software or for as long as the customer renews PCS). That is, under legacy US GAAP, exchange rights of this nature resulted in the entire arrangement being accounted for as a subscription (i.e. in those cases, the arrangement revenue would be recognized ratably over the subscription period).

In contrast, under Topic 606, those arrangements will not be accounted for as subscriptions. Rather, they will be accounted for as returns or, in some circumstances, as an arrangement that includes a right to unspecified additional software licenses, which results in a portion of the revenue recognized upon the transfer of the initial license(s) and a portion of the revenue recognized as the entity fulfills its obligation to provide unspecified additional software licenses.

Reseller considerations

If software entities grant resellers the right to exchange unsold software for other software (including software that runs on a different hardware platform or operating system), such exchanges were accounted for as returns under legacy US GAAP. This accounting, which included stock balancing arrangements, was on the basis that the reseller is not the ultimate customer.

Accounting for such exchanges as returns was required even if the entities required resellers to purchase additional software to exercise the exchange rights. Exchange accounting was only considered appropriate when conducted with the ultimate customer.

Topic 606 does not contain explicit guidance for exchange rights granted to resellers. Therefore, we do not believe that exchange rights with resellers would always be treated as return rights; instead, the criteria outlined above would apply regardless of where the customer resides on the distribution chain.

Entities still have to consider other guidance in Topic 606 (e.g. on consignment arrangements and the applicable transfer of control guidance, such as that in paragraphs 606-10-55-58B – 55-58C for licenses of functional IP) to determine if the reseller obtains control of the license to which the exchange rights apply.

Example C80.1

Right to exchange a software license

ABC Corp. enters into an arrangement with Customer to transfer a license to Product A, a basic word processing software product, for a nonrefundable fee of $500.

In addition, ABC grants Customer the right to exchange its Product A license for a generally equivalent (in terms of rights conveyed to Customer) license to Product B in six months when it is released. Product B is also a word processing software product; it contains essentially the same basic features and functionality of Product A except that Product B also contains a grammar-check feature that permits the user to check the grammatical consistency of text. A license to Product B is expected to be sold for $520 in separate transactions.

Customer is not entitled to continue using Product A if the Product A license is exchanged for a license to Product B. Generally, a license to Product B would not be considered to have more than minimal differences in price, functionality or features from a license to Product A.

ABC concludes that the right to exchange the Product A license for a Product B license is not an additional promised good or service in the contract. This is because Customer will not retain the rights to use Product A if it exchanges the Product A license for a Product B license.

ABC also concludes that the exchange right is not akin to a return because Product A and Product B have no more than minimal differences in price, functionality or features and the rights conveyed by the two licenses are generally equivalent. As a result, there is no accounting that must occur for the exchange right.

Example C80.2

Right to exchange a software license for an unspecified software license

ABC Corp. enters into an arrangement with Customer to transfer a license to Product A for $1,000. In addition, ABC grants Customer the right to receive full credit for the Product A license fee (i.e. no cash will be refunded) if Customer returns that license, and instead licenses any product introduced by ABC in the Product A family over a two-year period.

This return provision can be exercised only once and the estimated economic life of the Product A software is five years. If the Product A license is returned, Customer is no longer entitled to use Product A.

ABC concludes that it should account for the sale of the license to Product A as a sale with a right of return. This is because it cannot conclude that the unspecified software product for which Customer might obtain a license in return for the Product A license would have only minimal differences in price, functionality or features from Product A. The return right is not an additional promised item in the contract because Customer does not retain the right to use Product A if it is exercised. ABC does not expect based on its development plan, within the two-year period to which the right applies, to develop any software product within the Product A family that has significantly enhanced features or functionality.

Therefore, ABC will recognize revenue for the sale of the Product A license when the license is transferred to Customer. However, in accordance with the guidance on product returns, the transaction price is subject to the guidance on variable consideration, including the constraint on variable consideration. [606-10-55-22 – 55-29]

ABC estimates the following based on relevant evidence (e.g. from similar past offers and industry experience):

- that 40% of customers will exercise the right to exchange Product A;
- it is reasonably possible that up to 60% of customers will exercise the right; and
- it is remote that more than 60% of customers will exercise the right.

There are no costs to recover the license to Product A if it is returned and there is no cost basis to the license.

Accordingly, when the Product A license is transferred to Customer, ABC will recognize revenue of $400 (based on the reasonably possible returns of 60%). It is probable that recognizing this amount will not result in a subsequent significant revenue reversal when the uncertainty as to whether Customer will return Product A is resolved.

The introduction of the constraint on variable consideration results in a different outcome for this example than what would result under legacy US GAAP. This is because, under legacy US GAAP, ABC uses its best estimate that 40% of customers will exercise the right to exchange Product A. In contrast, under Topic 606, ABC must constrain that estimate with the intent that it be probable any subsequent adjustments are increases to revenue, rather than reversals. Consequently, in contrast to the example above, under legacy US GAAP, ABC would have:

— recognized revenue of $600 on delivery of Product A to Customer; and
— established a return reserve of $400 ($1,000 x 40%).

Example C80.3

Right to return software licenses in exchange for credit toward unspecified software licenses

ABC Corp. enters into an arrangement with Customer to transfer five-year term licenses to Products J, K, L and M. Customer has the right to return any of those licenses for a credit toward the purchase of licenses to any other ABC software products, including software products that do not yet exist at contract inception or when Customer initiates a return. Customer is not entitled to a cash refund under any circumstances and any return credit expires at the end of the five-year license term. The amount of the credit to which Customer is entitled declines during the license period (e.g. if Customer returns the Product J license on Day 1, Customer will receive a full credit of the contractual Product J license fee, but if Customer returns the Product J license at the end of Year 1, it will receive a credit equal to 80% of the contractual license fee).

Customer is entitled to return any of the licenses to which it obtains rights in the contract and can also return any licenses it obtains using a credit from the exchange of another software license (e.g. Customer could exchange its Product J license for a credit, which is used to acquire a license to Product Q and then exchange the Product Q license for a credit that could be used to acquire another license).

Customer’s return/exchange rights are unlimited and include rights to use return/exchange credits for licenses to unspecified software products and the amount of the available return/exchange credits decreases commensurate with Customer’s consumption of its time-based rights to use the initially licensed software. Therefore, ABC concludes that the return/exchange rights are akin to a right to obtain future additional software licenses (see Question C320). Assuming those rights are distinct, ABC allocates a portion of the transaction price to those unspecified additional software license rights and recognizes that revenue over the return/exchange rights period (in this case, the full five-year license period). Because the return/exchange rights are unlimited and the additional software licenses Customer can exchange into are unspecified, ABC concludes that recognizing that revenue on a time-elapsed basis is appropriate, consistent with the generally equal benefit Customer obtains from those rights over the license period.

Question C85

How should a software vendor account for a right to convert a software license to SaaS?

Background: A software vendor may enter into a contract to transfer a software license that provides the customer the right to convert the software license to a SaaS subscription for the same software. This question addresses contracts where the right is present at contract inception, whether explicit or implicit. See Question G131 and Example G131.1 for a discussion of modifications that convert a license to SaaS, and Question G132 for a discussion of modifications that add a right for the customer to convert a license to SaaS in the future.

Interpretive response: The conversion right could be a marketing offer, a material right, right of return or separate performance obligation depending on the facts and circumstances.

Scenario 1: The customer retains the right to use the software

If the customer retains its previous right to use the software in addition to obtaining access to the software on a SaaS basis, the contract provides the customer with an option to acquire a service (i.e. the SaaS) in addition to the software license. For example, a software vendor enters into a three-year term license and provides the customer an option to acquire SaaS for the remaining term while retaining its license. In this scenario, the software vendor must evaluate whether the option is a material right.

If the customer does not have to pay a fee for the SaaS or the option price is at a discount incremental to the range of discounts typically given for the SaaS to that class of customer in that geographical area or market, then that right is a 'material right' and constitutes a performance obligation in the contract – i.e. in addition to the initial promised software license. In contrast, when the price of the SaaS is commensurate with the stand-alone selling price of the SaaS, the right is generally accounted for as a marketing offer. See Questions C380 – C490 for further discussion of material rights. [606-10-55-42]

Scenario 2: The customer forfeits the license upon conversion

If the customer forfeits the software license upon conversion, the conversion right is generally accounted for as either (1) a right of return or (2) an optional purchase that may be a material right. Under either approach, if the conversion price would increase the contract price by an amount equal to or greater than the stand-alone selling price of the SaaS, the conversion right is effectively just a marketing offer. This is because the customer will have, in effect, paid a substantive amount for both the software license and the SaaS if it converts and, therefore, there is no implied refund or material right to account for.

Some believe a conversion right that is not a marketing offer is a right of return because the license is a product that will be exchanged for the right to receive a different service (i.e. the SaaS). Therefore, the item being forfeited is not of the same type, quality, condition and price as the service it will receive in exchange. Any discount from the stand-alone selling price of the SaaS in the conversion price is effectively a refund of the license fee and is estimated using the variable consideration guidance. See C80 for further discussion on exchanges of software licenses. [606-10-55-22 – 55-24]

Others believe that a conversion right that is not a marketing offer should be accounted for as a material right. This is premised on a view that the conversion right grants the customer the option to obtain an additional service at an incremental discount from its stand-alone selling price rather than exchanging one product for another product. The software vendor then accounts for the material right in a manner consistent with the accounting for any other material right, which includes deferring the relative stand-alone selling price allocated to the material right until the underlying service is provided or the right expires. [606-10-55-22 – 55-24]

Issue 2 of EITF Issue 19-B "Revenue Recognition – Contract Modifications of Licenses of Intellectual Property" was added to the FASB agenda to address diversity in practice in the accounting for the revocation of licensing rights (including conversions of term software licenses to SaaS). The EITF discussed both views as part of its deliberations but did not reach a consensus about which of these views was acceptable or preferable.

In the absence of further guidance from the FASB or the SEC staff, we believe either of the above-described views are acceptable.

An entity's accounting under either view should reflect its history and expectations related to conversions; some of the judgments involved may be subjective in nature.

— The right of return approach results in revenue being deferred and adjusted each reporting period using the variable consideration guidance. Changed experience or expectations of customer conversions may affect the entity's estimates of variable consideration over time. For example, if experience shows that customers are exercising the conversion option at a higher rate than previously expected, this would likely result in an increase to the amount of license revenue constrained and deferred by the entity when it transfers the license to the customer.

— The material right approach requires an estimated stand-alone selling price for the conversion right, which would incorporate the likelihood and timing of expected conversion. Unlike the right of return model, the stand-alone selling price of the material right is not adjusted after contract inception, and therefore the revenue deferred for the conversion option does not change before it is exercised (and the SaaS provided) or expires. However, the entity will need to update its stand-alone selling price estimates for conversion rights provided in new contracts to reflect changes in expectations about conversions.

Scenario 3: Flexible arrangement

In some contracts the customer is permitted a designated number of concurrent users (e.g. 100 concurrent users), but the mix between on-premise and SaaS users can vary over time. For example, the customer would be permitted to have all 100 concurrent users accessing the on-premise software, all 100 concurrent users accessing the software on a SaaS basis, or any mix in between. These contracts consist of at least two promises, a software license and SaaS that would be evaluated to determine whether they are distinct. See

Example C310.4 for a scenario where the license and SaaS are distinct and Question C310 on evaluating when a license and SaaS are distinct.

Question C90

How does a pattern of granting concessions to customers in the form of free or significantly discounted goods or services affect an entity's identification of the promised goods or services in contracts with its customers?

Interpretive response: Promised goods or services include those implied by an entity's customary business practices, published policies or specific statements if a customer would reasonably expect to obtain additional goods or services as a result of entering into the contract with the entity. Therefore, an entity's historical pattern of giving customers free or significantly discounted goods or services may create additional promised goods or services that an entity would need to identify in a contract with the customer. This may include an implied promise to deliver a good or service or an implied material right to obtain a good or service at a significant discount.

The following are examples (not exhaustive) that may represent implied promises, if a pattern exists of granting them to customers:

— providing discounted or free services or products that were not included in the terms of the original contract
— allowing the customer to access or receive additional products (including additional licenses) without a commensurate increase in the transaction price
— for time-based services, extending the time period for which a customer receives the service for little or no additional consideration
— extending the geographic area in which a customer can use a software license
— permitting additional uses of licensed software (if the license included use restrictions initially).

Price concessions do not affect the determination of the promised goods or services in the contract. Price concessions *expected* at contract inception result in the transaction price for the contract being variable (see *Chapter D – Step 3: Determine the transaction price*).

Unexpected concessions, whether price concessions or additional good or service concessions, are accounted for as contract modifications – e.g. as a change to the price and/or scope of the contract when they occur – they do not affect the transaction price of the contract, or create implied promised goods or services, at contract inception. Unexpected concessions generally arise from situations where a pattern of granting concessions did not exist at the time of entering into the contract and there was no reasonable expectation of granting one.

Example C90.1
Pattern of granting concessions

ABC Corp. licenses ERP software to its customers. ABC is a second-tier player in the ERP software market; it therefore has a significant incentive to try to ensure it keeps its existing customers from moving to one of the larger software providers, and to try to develop a competitive advantage against the larger ERP software providers.

ABC's contracts do not generally include rights to new software modules that are developed; they hope to be able to charge their customers for those. However, ABC has developed a practice of providing any new modules to its largest customers or those nearing the end of their current term licenses or their current PCS term free of charge. It does this to incentivize those customers to renew their term license and/or their PCS services.

Because customers in the marketplace communicate (e.g. personnel move from one customer to another), ABC's customary business practice is known by both renewing and prospective customers.

ABC concludes that its history of providing free licenses to additional software products to its customer base creates an implied promise in its software license contracts to transfer rights to use unspecified additional software products, when-and-if developed. The duration of that promise depends on ABC's customary business practice – i.e. ABC will need to determine for what period time it typically provides such free items, which may differ for different classes of customer (e.g. ABC's largest customers versus smaller customers, and term license customers versus perpetual license customers).

Question C320 and Examples C320.1 and C320.2 discuss whether unspecified additional software product rights are distinct from a transferred software license.

Comparison to legacy US GAAP

Accounting effect of a history of granting concessions

Legacy US GAAP software revenue recognition guidance described changes to an arrangement that constitute concessions, including:

— changes that would have affected the original amount of revenue recognized;
— changes that reduce the arrangement fee or extend payment terms; and
— changes that increase deliverables or extend the customer's rights *without* a commensurate increase in fees.

Examples of each type of concession were provided in the legacy guidance. The examples of concessions that increased deliverables or extended the customer's rights are consistent with the examples provided in this publication, including *Chapter D – Step 3: Determine the transaction price*.

Under legacy US GAAP, concessions could result in all contract revenues being deferred. A pattern of granting concessions called into question the fixed or determinable nature of the fees under the arrangement, meaning none were eligible for recognition until the risk of concession had been abated. Often this was significantly later than when revenue would have been recognized absent the entity's pattern of granting concessions; and could be after all of the stated elements in the contract were delivered and all of the arrangement fees collected.

The accounting effect of a pattern of concessions under Topic 606 is considerably different from the effect under legacy US GAAP.

— An entity's historical pattern of granting concessions that reduce the transaction price or extend payment terms affects the measurement of the transaction price under Topic 606 (creating variable consideration), rather than delaying revenue recognition altogether. This may result in a portion (but typically not all) of the contract consideration being recognized when the promised goods or services are transferred to the customer – with some portion being deferred until the uncertainty associated with the potential concession is resolved.

— An entity's historical pattern of giving customers free or significantly discounted goods or services may create additional, implied promised goods or services (including material rights) that an entity would need to account for in the contract. This will typically not result in deferral of all contract revenues but rather a *portion* of the transaction price will be deferred until either those implied goods or services are transferred to the customer or the risk of concession has abated.

Accounting for unexpected concessions

Under legacy US GAAP, the accounting for a concession that was not reasonably foreseeable when the arrangement was entered into occurred when the concession was granted and depended on the nature of the concession.

If the substance of the concession was the right to return one product for a new product, cash or other benefit, the concession was accounted for as a return right under legacy Subtopic 605-15.

However, if the form or substance of the concession was a modification of the original arrangement to provide additional deliverables, then either of the following accounting policies were acceptable alternatives that could be elected and applied consistently by the entity:

— Prospective approach: The concession was accounted for as a new arrangement or a contract renegotiation or modification. Any remaining deferred revenue from the original arrangement plus any further consideration to be received under the modified arrangement were reallocated to the deliverables under the modified arrangement. If the remaining revenue allocated to an undelivered element did not equal or exceed estimated remaining costs for the undelivered element – i.e. because some or all arrangement consideration has been recognized as revenue before the modification – a loss was recognized at the date of the concession. For purposes of applying the prospective approach, it was necessary to analyze the facts and circumstances to determine the original arrangement(s) to which the concession related for purposes of identifying the existing deferred revenue that would be considered for reallocation to the elements of the modified agreement.

— Balance sheet approach: Alternatively, the concession was accounted for similar to a return. The entity increased deferred revenue to the full amount that would have been recorded at that date had the concession been part of the original contract, with a corresponding reduction in revenue for the period in which the concession was granted.

Under Topic 606, an unexpected change in the scope of the contract (i.e. by adding additional goods or services) is accounted for as a contract modification. The accounting for a contract modification that increases the scope of the contract through a concession – i.e. by granting free or significantly discounted additional goods or services – largely depends on whether the additional goods or services and the remaining goods or services that were part of the existing contract are distinct from the goods or services transferred before the modification.

If they are distinct, the modified contract is accounted for prospectively – i.e. there is no cumulative effect adjustment resulting from the modification. If the additional goods or services and the remaining goods or services that were part of the existing contract are not distinct from the goods or services transferred before the modification, there will typically be a cumulative effect adjustment resulting from the modification.

Chapter G – Contract modifications, addresses the accounting for contract modifications in further detail.

Question C100

Are promises to provide services to a reseller's end customers performance obligations of the software entity in its contract with the reseller?

Interpretive response: It depends. To illustrate, assume a software entity transfers control of software licenses to its reseller or distributor customer. The entity then promises other goods or services as sales incentives to end customers to encourage the sale of those products that have become part of the intermediary's inventory. The sales incentives might comprise free technical support or unspecified updates/upgrades/enhancements.

If the promise to transfer goods or services that are sales incentives is made at the time of transfer of control of the related good or service to the intermediary (i.e. the distributor or reseller), it should be identified as a promised good or service of the contract between the entity and the intermediary. This would occur when the promise to transfer those goods or services was made in the contract, or implied by an entity's customary business practices, published policies or specific statements such that it created a reasonable expectation of the ultimate customer that the entity will transfer a good or service.

However, if the promise was made after the transfer of control of the license to the intermediary (and no implied promise was made – see preceding paragraph), the promise would not be a promised good or service in the original sale between the entity and its customer (i.e. the distributor or reseller), when the distributor or reseller is not solely an agent of the entity in its transaction with the end customer. In this case, all the revenue is recognized when the goods are transferred to the reseller or distributor and the entity accrues the cost of the incentive when the promise is made. However, once the entity makes an initial offer it needs to consider whether it establishes a pattern that creates an expectation by the intermediary or end customer. As a consequence, this scenario may be limited.

Example C100.1

Technical support and unspecified upgrade rights provided to a reseller's end-user customers

Description of the contract

ABC Corp. licenses its software to satellite radio providers. ABC has entered into a licensing arrangement with Customer that, for a fixed upfront fee, permits Customer to sell ABC's software together with Customer's satellite radio hardware systems.

ABC has a customary business practice of providing telephone support, as well as unspecified updates, upgrades and enhancements (collectively, PCS) to Customer's customers (end user) free of charge. End users and Customer reasonably expect ABC to continue this practice.

Evaluation

ABC evaluates whether the technical support and the right to receive unspecified updates, upgrades and enhancements are additional promised services (collectively, PCS) in its contract with Customer. ABC notes the promise to provide PCS free of charge to end users is a sales incentive that is an additional promised service in the contract. Based on ABC's customary business practice, Customer and end users reasonably expect (at the time of transfer of control of the software license to Customer) to receive the PCS.

As a result, the PCS is an additional promised service in its contract with Customer. If that PCS is a separate performance obligation (see Questions C150-C170), ABC will defer a portion of the proceeds from the sale of the software license to the reseller. That portion will be recognized as revenue as ABC satisfies the PCS performance obligation (see Question F235).

Software licenses

Question C110

Are software licenses capable of being distinct in accordance with paragraph 606-10-25-19(a)?

Interpretive response: Generally, yes. Being capable of being distinct means that a customer can benefit from the software license on its own or together with other readily available resources. Therefore, even if the economic benefits that can be derived from the software license on its own or together with readily available resources might be minor compared to the economic benefits the customer can obtain from the software license together with the other goods or services promised in the contract, the software license will generally be considered capable of being distinct.

This conclusion is supported by the fact that each example of a software license in Topic 606, including those for which the conclusion is that the software license is *not* separately identifiable from a promised service in the contract, concludes the software license is capable of being distinct. [606-10-25-19(a); Example 10 Case C – paragraphs 606-10-55-140D – 55-140F; Example 11 Case A – paragraphs 606-10-55-141 – 55-145; Example 11 Case B – paragraphs 606-10-55-146 – 55-150]

However, a software license may not *always* be capable of being distinct and how this determination is reached may vary depending on the nature of the software being licensed. A software entity's conclusion and/or basis for evaluation in this regard may differ depending on whether the software is off-the-shelf software or core software.

Off-the-shelf software is often defined as software marketed as a stock item that customers can use with little or no customization. Off-the-shelf software can be added to a contract with insignificant changes in the underlying code and it could be used by the customer for the customer's purposes upon installation. Customers generally can benefit from off-the-shelf software on its own or together with implementation or other services that are readily available from the software vendor or other third-party professional service providers. If significant services, such as to significantly modify or customize the software code, were necessary for the software to provide even a baseline economic benefit to the customer, this would call into question whether the software was really off-the-shelf software, as opposed to core software.

Core software is generally defined as an inventory of software that vendors use in creating other software. Core software is not delivered 'as is' because customers cannot use it unless it is customized to meet system objectives or customer specifications. A software product that is never licensed without significant additional coding services is a strong indicator that the product may be core software.

Core software does not, in most circumstances, provide the customer with benefit on its own; it can only provide benefit to the customer if readily available resources, such as available services, exist that would allow the customer to benefit from use of the software. Readily available resources could consist of (1) the entity's own customization services if it sells such services separately (i.e. in contracts separate from the licensing of its software) or (2) the customization services of a third party.

Given that, in many cases, significant customization or modification of an entity's software cannot be performed by a third party (the second scenario), there are likely to be many instances where there is no third party that can customize the entity's core software to enable it to function. In such circumstances, unless the entity sells such services separately (the first scenario), core software may not provide benefit to the customer independent of other goods and services with which it is bundled. Therefore, it will not be capable of being distinct.

Question C120

If an arrangement includes multiple software licenses (e.g. licenses to multiple software applications or modules), which may or may not be transferred to the customer at different points in time, how should an entity evaluate if those licenses are separate performance obligations?

Interpretive response: Two or more software licenses will typically be distinct if the licenses are merely 'additive' to each other. They will typically not be distinct when the different licenses have a 'transformative' or significantly 'magnifying' effect on each other.

Put another way, if an entity licenses software products A and B to a customer, the distinct analysis would generally hinge on whether:

— the combination of A + B equals AB (i.e. the combined functionality of the two applications is merely the sum of the two licenses' individual functionalities). In that case, the two licenses would generally be distinct from each other; or

— the combination of A + B equals X (i.e. the combination of the two elements results in incremental or changed functionalities that don't exist in either software application separately) or AB^x (i.e. the combination of the licenses produces a significantly enhanced *level* of functionality that is greater than the aggregate of the two elements' individual functionalities). Either of these scenarios would generally suggest that the two licenses are not distinct from each other.

This notion also affects the distinct analysis for other software-related elements, such as in determining whether software and SaaS elements are distinct from each other (see Question C310) and whether a software license and certain implementation/configuration services are distinct from each other (see Question C260).

We believe that the analysis above is consistent with the underlying principle for the distinct evaluation described by the FASB in the Basis for Conclusions to ASU 2016-10.

Excerpt from ASU 2016-10

BC29. The Board intends to convey that an entity should evaluate whether the contract is to deliver (a) multiple goods or services or (b) a combined item or items that is comprised of the individual goods or services promised in the contract. That is, entities should evaluate whether the multiple promised goods or services in the contract are outputs or, instead, are inputs to a combined item (or items). The inputs to a combined item (or items) concept might be further explained, in many cases, as those in which an entity's promise to transfer the promised goods or services results in a combined item (or items) that is greater than (or substantively different from) the sum of those promised (component) goods and services.

BC32. …The separately identifiable principle is intended to consider the level of integration, interrelation, or interdependence among promises to transfer goods or services. That is, the separately identifiable principle is intended to evaluate when an entity's performance in transferring a bundle of goods or services in a contract is, in substance, fulfilling a single promise to a customer. Therefore, the entity should evaluate whether two or more promised goods or services (for example, a delivered item and an undelivered item) each significantly affect the other (and, therefore, are highly interdependent or highly interrelated) in the contract. The entity should not merely evaluate whether one item, by its nature, depends on the other (for example, an undelivered item that would never be obtained by a customer absent the presence of the delivered item in the contract or the customer having obtained that item in a different contract)…

Professional services are discussed starting at Question C220. However, we believe that professional services provided to effect a software system (or solution) by implementing/integrating multiple software applications that are not distinct from each other (e.g. as described in the preceding paragraphs) would typically provide a 'significant integration service'. An example is the installation and interfacing of multiple, non-distinct software applications that comprise the system/solution. The professional services would be an additional input, together with the multiple, non-distinct software licenses, to the combined system/solution output for which the customer contracted, and therefore such professional services would not be distinct from the software licenses.

Post-contract customer support (PCS)

Question C130

Is the nature of an entity's promise to provide technical support or unspecified (when-and-if available) updates, upgrades and enhancements a stand-ready obligation?

Technical support

Interpretive response: Technical support will typically be a stand-ready obligation. This is because software entities that provide technical support usually maintain an infrastructure – e.g. dedicated customer support personnel, a call center and/or a website for online support assistance – that 'stands ready' to provide support to customers when-and-as needed. In addition, customers generally have the right and ability to obtain such support when-and-as needed throughout the support period and are not limited to a defined number of support calls or requests (subject to possible restrictions on times of day or days of the week that support is available).

However, if the technical support obligation is to provide a specified number of support events (or up to a specified number of support events that is substantive – i.e. it is not in excess of any realistic expectation of the customer's use of those services), then the technical support obligation is not a stand-ready obligation.

Promise to provide unspecified updates, upgrades and enhancements

Interpretive response: A promise to provide unspecified updates, upgrades and enhancements will also be a stand-ready obligation *when* the nature of the entity's promise is to transfer an undefined number of updates, upgrades or enhancements (i.e. any and all) that are developed during the support period. In that case, the customer benefits throughout the support period from the assurance that any updates or upgrades developed by the entity during the period will be made available.

In contrast, if an entity's promise to the customer or its customary business practice is to provide a defined number of updates, upgrades or enhancements (e.g. a single release each year with all of the accumulated updates, upgrades and enhancements developed since the previous year's release) that would typically suggest the nature of the entity's promise is to transfer that defined number of releases. It is not a stand-ready obligation to transfer any and all updates, upgrades and enhancements (of an undefined type and quantity) during the support period.

If the nature of the entity's promise to provide unspecified updates, upgrades and enhancements is that of standing ready to transfer to the customer such items when-and-if they become available, the customer is generally benefitting evenly throughout the obligation period from the assurance that any such items developed by the entity during the period will be made available to it. Therefore, a time-based measure of progress will typically be appropriate.

However, a measure of progress other than time-based may be appropriate in some circumstances even when the entity's promise to provide unspecified updates, upgrades and enhancements is a stand-ready obligation. At the January 2015 meeting of the TRG, members generally agreed with members of the FASB staff that a straight-line, time-based measure of progress should not always be applied to a stand-ready obligation.

For example:

- If it is expected (based on an explicit promise to the customer or the entity's customary business practice) that releases will always or predominantly occur at a specific time (or in a specified period – e.g. the fourth quarter) each year, an input-based measure, reflective of the uneven efforts that the entity will undertake to transfer the releases to the customer each year of the obligation period, may be appropriate.
- It may be expected at contract inception that there will be a significant upgrade or enhancement (that is not a *specified* upgrade or enhancement) transferred to the customer at a specific point in time during the support period (e.g. the entity expects to release principally bug fixes and other minor updates throughout the support period, but also expects to release a significant enhancement or version upgrade 12 months after contract inception that will substantially enhance the licensed software). In that case, the benefit the customer will receive from the unspecified updates, upgrades, and enhancements provision may not be even throughout the

obligation period. Therefore, a different measure of progress (i.e. other than one that is time-based) may be appropriate.

Question C140

If an obligation to provide technical support services or one to provide unspecified update/ upgrade/enhancement rights is a stand-ready obligation, is the obligation a 'series' of distinct service periods?

Interpretive response: In general, if the obligation, either to provide technical support or to provide unspecified updates, upgrades and enhancements, is a stand-ready obligation (see Question C130), it will qualify as a series. For example, a two-year technical support or unspecified updates/upgrades/enhancements obligation would be a series of distinct monthly, weekly or daily support periods.

For a service obligation to be a series, there generally must be multiple time periods within the overall obligation period that:

a. are distinct from each other;
b. are substantially the same;
c. are satisfied over time (based on the over-time recognition criteria in paragraph 606-10-25-27); and
d. have the same pattern of transfer to the customer – e.g. the entity would measure progress toward complete satisfaction of each distinct service period obligation using the same measure of progress.

Taking each of the above criteria in turn for a multi-year technical support or unspecified update/upgrade/enhancement rights obligation:

a. **Distinct.** Each service period (e.g. each month, or even each day) within the larger obligation period that the entity stands ready provides benefit to the customer on its own – i.e. each service period is capable of being distinct. In addition, the entity's promises to provide support services or transfer any updates, upgrades or enhancements released in one service period is separately identifiable from those service periods preceding and following it – i.e. no one period of service is essential to, dependent on or significantly modifies or customizes another period of service.

b. **Substantially the same.** Even though the mix and quantity of activities that the entity will perform each distinct period (e.g. number of support inquiries fielded or number and type of updates, upgrades and/or enhancements released) may differ, the nature of the entity's promise each period is substantially the same. This conclusion and underlying rationale is consistent with examples of transaction processors and electricity suppliers discussed by the TRG at its July 2015 meeting, as well as one for a hotel manager in Topic 606 (Example 12A). In each of those examples, the quantity and mix of activities differs from one distinct service period to another but, because the nature of the entity's promise was the same integrated or stand-ready service each period, each service period was deemed to be 'substantially the same'.

c. **Satisfied over time.** Because the nature of the entity's promise is a stand-ready obligation, rather than to provide specified goods or perform specified activities, the customer consumes and receives benefit from the technical support services and the unspecified update/upgrade/enhancement rights throughout the overall obligation period. Therefore, the entity's promise to perform each service period is satisfied over time.

d. **Same pattern of transfer.** Regardless of the measure of progress selected for the stand-ready obligation (see Question C130), we would expect the same measure of progress to be applied to each distinct service period.

Question C150

Are the component services of PCS separate performance obligations?

Post-contract customer support (PCS)

PCS includes the right to receive services (typically telephone support and maintenance) or unspecified upgrades and enhancements, or both, offered to users or resellers, after the software license period begins, or after another point in time as provided for by the PCS agreement. PCS does not include (i) installation or other services directly related to the initial license of the software, (ii) specified upgrade rights even if a customer would otherwise be entitled to the upgrade right as a subscriber to PCS, or (iii) rights to additional specified or unspecified software products.

Interpretive response: PCS often involves, at a minimum, some form of technical support and a promise to provide the customer with updates/upgrades or other enhancements on a when-and-if available basis. This is illustrated in the implementation guidance to Topic 606 (Example 11).

Technical support services and a promise to provide unspecified updates, upgrades and enhancements will generally be distinct from each other because:

— **each service is capable of being distinct.** Customers receive benefit from each service together with the associated software license to which the service relates; and the software license is transferred before either providing technical support or unspecified updates, upgrades or enhancements; and

— **the two promises to provide those services are separately identifiable:**

  – the two services are not inputs to a combined output for which the software vendor provides any significant integration service;
  – the provision (or not) of each service does not significantly modify or customize the other; and

– a software entity could typically provide either service irrespective of whether it provided the other, which means the two services are not highly interrelated or interdependent.

Even though technical support services and unspecified update, upgrade and enhancement rights will typically be distinct, we expect that many software entities will account for PCS as a single performance obligation. This is because they will conclude that the technical support and the right to unspecified updates, upgrades and enhancements are both stand-ready obligations being provided over the same period of time and have the same pattern of transfer to the customer (e.g. the entity would apply a time-based measure of progress to each) – see Question C130. Topic 606 permits entities to account for two distinct goods or services as a single performance obligation if they are concurrently delivered (i.e. in this case, if the technical support services and the unspecified update/upgrade/enhancement rights are co-terminus) and have the same pattern of transfer to the customer. [ASU 2014-09.BC116]

Comparison to legacy US GAAP

Legacy Subtopic 985-605 defined PCS as a single software-related element. Consequently, entities did not consider separating the components of PCS, even when the customer paid for 'platinum' PCS – e.g. 24/7 technical support and rights to receive certain significant upgrades or enhancements that were not included as part of the entity's 'standard' PCS.

In addition, because the component services of PCS are rarely, if ever, sold separately from each other by software entities, they generally would not have been separable under legacy US GAAP. This is because entities would have been unable to establish vendor-specific objective evidence of fair value (VSOE) for those components.

The requirement under Topic 606 to separate the technical support component of PCS from the right to unspecified updates, upgrades and enhancements in some cases (as outlined in this question) will be a significant change for those entities that need to do so.

Question C160

Are technical support services distinct from the software license to which they relate?

Interpretive response: In general, yes. Technical support services and the software license to which those technical support services relate will be distinct from each other.

While the software license will generally be capable of being distinct for the reasons outlined in Question C110, the technical support services will be capable of being distinct in accordance with paragraph 606-10-25-19(a). This is because the customer will benefit from those services together with the software license transferred to the customer before providing the technical support services.

The entity's promises to transfer the software license and to provide technical support services will typically be separately identifiable in accordance with paragraph 606-10-25-19(b) – i.e. not inputs to a combined item. This is because:

— neither the license, nor the support services, customize or modify the other – e.g. technical support services do not change or enhance the functionality of the software; and
— the software entity is able to transfer the license and provide the support services independently of each other. For example, the entity is able to transfer the software license without ever providing support services to the customer, and is also able to provide support services to a customer that acquired its license to the software product from a third party, such as a reseller.

Consequently, it will generally be clear that there is neither a significant integration service being performed by the software entity to create a combined item comprised of the licensed software and the support services, nor any significant level of interrelationship or interdependence between the license and the support services.

Question C170#

How does a software vendor evaluate whether a software license is distinct from a promise to provide unspecified updates, upgrades and enhancements?

Interpretive response: If a software license is capable of being distinct (see Question C110), a promise to provide unspecified updates, upgrades and enhancements to that software license will also be capable of being distinct. This is because the customer will benefit from that promise together with the software license transferred to customer before it could ever receive updates, upgrades or enhancements to the software.

In most contracts, the promise to transfer the software license and a promise to provide unspecified updates, upgrades or enhancements related to that software product will be separately identifiable from each other. This is based on the following reasons (in accordance with paragraph 606-10-25-19(b)).

— Similar to the discussion in Question C160 related to technical support services, the software entity is able to transfer the license and provide future updates, upgrades and enhancements independent of each other. The entity can, and in general must, transfer the initial software license before it can provide updates, upgrades or enhancements to the software. In addition, as with technical support services, the entity is able to transfer a license to the software without promising to provide future unspecified updates, upgrades or enhancements and is able to provide such items to a customer that acquired its license to the software product from a third party, such as reseller. Consequently, the license and unspecified update/upgrade/enhancement rights are not highly interrelated or interdependent.

— The promise to later (i.e. subsequent to transfer of the initial software license) transfer any updates, upgrades or enhancements produced means that the entity is not providing a significant integration service to transfer a single, combined output that uses the initial license and later updates, upgrades or enhancements as inputs.

— The updates, upgrades and enhancements will modify the software to which the customer has rights. However, in general, many updates or upgrades that will be received during the course of a support period will not significantly modify the software – i.e. the update, upgrade or enhancement may be minor. And frequently an update, upgrade or enhancement provided to the customer will not modify the *customer's instance* of the software because the customer is not required to, and will not, install it.

However, in more limited circumstances, Topic 606 illustrates that a software license may not be distinct from a promise to provide unspecified updates, upgrades or enhancements. This is because there is, effectively, a reasonable certainty that updates will be provided that are *integral* to the customer's ability to continue to derive substantive benefit from the software license (i.e. its utility to the customer) throughout the license period. [Ex 10 Case C – paragraphs 606-10-55-140D – 55-140F, ASU 2016-10.BC33(b)]

Example 10 Case C in Topic 606 further illustrates, as part of the basis for the conclusion reached, that the updates are expected to significantly modify the functionality of the software by enabling the software to protect the customer from a significant number of additional viruses. The typical anti-virus scenario differs from the discussion in the third bullet above in that customers almost universally install anti-virus updates and upgrades received; this is because the fundamental purpose of the arrangement is to provide ongoing protection to the customer from existing *and* especially emerging threats, which *requires* frequent and substantive updates to deal with emerging threats.

We expect the conclusion that a software license and a promise to provide unspecified updates, upgrades and enhancements are not distinct from each other to, in general, be supported by evidence that:

— the utility of the software will degrade *significantly* during the license period (and not predominantly at or near the end of that period only) if updates, upgrades or enhancements are not provided;
— the updates are, in fact, integral to the customer continuing to obtain substantive utility from the software license; and
— the provision of substantive updates is inherent to the customer value proposition – i.e. a customer would view these updates as essential and generally expect these updates as a *minimum* requirement to obtain its business.

The first two of these might be evidenced, for example, by information supporting that the vast majority of customers regularly and timely download updates, upgrades or enhancements released. If customers *do not* do so, that would call into question whether expected updates are truly integral to maintaining the utility of the software, and therefore whether the license and the updates are inputs to a combined item or solution.

Meanwhile, the essential nature of the unspecified updates, upgrades and enhancements right might be evidenced, for example, by the entity's promotional and marketing materials and/or by the nature and extent of the entity's efforts to satisfy that promise – e.g. a standing team and/or process to timely identify and make necessary updates or upgrades.

Example C170.1
Software license and PCS

ABC Corp. enters into a contract with Customer to provide a three-year license to Customer for its off-the-shelf software and also to provide both technical support services and any updates, upgrades and enhancements developed during the three-year term.

ABC never sells its software licenses, its technical support services, or its unspecified update, upgrade or enhancement rights separately. The software functions to its specifications without the support services or the updates, upgrades or enhancements.

In addition, the following facts are relevant:

— The utility of the software (i.e. its ability to provide benefit or value to the customer) is not expected to degrade significantly over the three-year term if no updates, upgrades or enhancements are delivered to the customer (or the customer chose not to install them).

— ABC maintains a substantive infrastructure to provide support to customers when-and-as needed.

— ABC has historically provided releases ranging from minor bug fixes, minor and major version upgrades (i.e. 'right of the dot' and 'left of the dot' upgrades), and functionality enhancements to its customers, but the type, timing and quantity of such releases has not been consistent or predictable in the past. This means that the type, timing and quantity of updates, upgrades and enhancements that will be provided is unpredictable at contract inception.

ABC first identifies that there are three promised goods and services in the contract: the software license, technical support services, and the promise to provide unspecified updates, upgrades and enhancements.

Next, ABC concludes that it will account for the technical support services and the promise to provide unspecified updates, upgrades and enhancements as a single performance obligation; this is because they will be provided over the same period (three years) and have the same pattern of transfer to the customer. ABC concludes that both the technical support services and the unspecified upgrade rights are stand-ready obligations based on:

— the technical support infrastructure that ABC maintains; and
— the indeterminate type, quantity and timing of support services and updates, upgrades or enhancements that ABC will provide over the three-year term.

These factors also support that a time-based attribution method for both of those promised services would be reasonable.

Lastly, ABC concludes that the software license and the PCS (the combined technical support and unspecified update, upgrade and enhancement rights) are distinct from each other based on the following:

— ***The software license and the PCS are capable of being distinct.*** Because the software functions to its specifications without the PCS, Customer can benefit from the software license on its own without the PCS and can benefit from the PCS together with the software license transferred before the performance of the PCS.

— ***The entity's promise to transfer the software license and to provide PCS are separately identifiable.*** ABC would be able to transfer the software license and the two components of the PCS independently. This supports that the license and the PCS are not highly interrelated or interdependent, and that the entity is not providing a significant integration service in the contract to produce a combined output (using the license and the PCS as inputs). Further, neither the technical support nor the unspecified updates, upgrades or enhancements is expected to *significantly* modify or customize the licensed software. Finally, the utility of the software to Customer will not significantly degrade during the license period if updates, upgrades or enhancements are not provided; therefore, this example is not analogous to the anti-virus example in Topic 606.

Consequently, ABC concludes that there are two performance obligations in this contract: the software license and PCS.

Under legacy US GAAP, because ABC never sells the undelivered PCS on a stand-alone basis, it would not have been able to establish VSOE for the PCS services; therefore, ABC would not have separated the license element from the PCS services.

Example C320.2 demonstrates a scenario where a promise to provide unspecified updates, upgrades and enhancements (as well as a promise to provide the right to use unspecified future software products) is *not* distinct from an initial software license.

Example C170.2
Software license and updates (1)

ABC Corp. enters into a contract with Customer to provide a three-year term license to Customer for its trade compliance (TC) software and to provide updates to critical trade data (i.e. content) that the software uses to assist Customer in complying with trade regulations.

The trade data includes restricted party lists, import/export regulations (including duties, taxes and fees), freight rates, Free Trade Agreement rules and transportation schedules/tariffs. The content updates deliver the latest version of the contracted-for trade data (similar to the manner in which anti-virus software provides updated virus definition files).

Content updates are provided on a when-and-if available basis throughout the three-year term, and the right to content updates is co-terminus with the license term. TC licenses are never sold without the content updates.

ABC considers the following additional facts.

1. There are typically multiple content updates provided to a customer each day during the license term.
2. Content updates are automatically 'pushed' to customers and universally implemented by customers as soon as they are made available.
3. Customers rely on the content updates to comply with US trade law, and the laws and regulations in many other countries. Failure to receive timely information about changes to relevant trade data could result in the customer failing to comply with trade laws and regulations, with potentially significant ramifications. For example, failure to comply with trade laws and regulations could subject the customer to penalties or fines, possible 'cease and desist' orders from Customs authorities and other legal issues. There also could be shipment/delivery delays or reputational damage resulting from trade compliance issues that result in lost or reduced business.

Although ABC concludes that the software license and the content updates are capable of being distinct, they are **not** distinct from each other (i.e. they are not distinct in the context of the contract) and, therefore, are a single performance obligation to Customer. This is because, based on the key facts (Nos. 1 - 3) outlined above, ABC determines that the utility of the software to Customer (i.e. the benefit Customer will obtain from its right to use the software) will significantly degrade during the license period if ABC does not provide content updates. The content updates are integral to the customer obtaining its intended benefit from the TC software license. This is because Customer's use of the TC software is intended to protect Customer from costly trade noncompliance issues, and without frequent and timely updates, the TC software will not perform that function adequately for more than a minor portion of the three-year license term.

Consequently, ABC concludes that its promises to grant the TC license and to provide unspecified content updates are not separately identifiable; the TC license and the content updates are, in effect, inputs to the combined item (a trade compliance solution) that Customer entered into the contract with ABC to obtain.

Example C170.3**

Software license and updates (2)

ABC Corp. enters into a contract with Customer to provide a one-year term license and co-terminus PCS to Customer for its project management software (Product PM). ABC's project management software is designed to complement and interoperate with software of an unrelated third party (XYZ Corp.). It does not have meaningful independent functionality (i.e. separate from interacting/interoperating with XYZ's software). PCS includes technical support and unspecified updates, upgrades and enhancements. ABC's contract expressly refers to Product PM updates for continued interoperability and compatibility with XYZ's software as an element of the PCS.

ABC evaluates whether its promises to transfer the Product PM term license and provide unspecified updates to the Product PM software for continued XYZ product interoperability and compatibility are separately identifiable from each other. ABC considers the following key facts.

1. ABC prominently markets Product PM's interoperability and compatibility with XYZ's complementary software. ABC's experience with Product PM customers – e.g. in negotiations, RFPs, post-implementation support, etc. – suggests this interoperability and compatibility are integral features to customers' decisions to license Product PM.
2. ABC's history with Product PM and XYZ's software shows that many XYZ software updates create *significant* interoperability/compatibility issues with Product PM if Product PM is not also updated, and ABC must test all XYZ software updates to know whether a significant interoperability/compatibility issue will result. Product PM would generally not be useful to customers for the duration of any such issue. Therefore, ABC maintains a regular connection to XYZ's development team (i.e. regular meetings and participation in all XYZ software beta or other early release version testing) so that it can timely test, and where necessary, enact critical interoperability/compatibility updates concurrent with XYZ software releases to customers.
3. Observable information demonstrates that Product PM users generally use the product regularly; that is, it is a regularly used application by licensees such that significant interoperability or compatibility issues would create almost immediate and substantive ongoing issues for them.
4. Year to year, the number of XYZ software updates that create significant interoperability or compatibility issues varies, but there have been multiple such XYZ software updates each year since Product PM's inception.
5. XYZ's software is regularly updated; in general, at least 8 - 10 times per year. However, ABC knows from customer interactions and its relationship with XYZ (see key fact #2) that XYZ customers generally do not implement all XYZ software version upgrades (e.g. an XYZ customer likely does not update with *each* version upgrade), but it is only a minor portion that do not upgrade their XYZ software at all during a one-year Product PM license term.
6. ABC can observe that 81% of Product PM licensees have upgraded *at least* once during the last 12 months from the Customer contract date, and that number remains relatively constant at 80 - 84% over the last three years on a rolling 12-month basis. In that regard, ABC considers that:
   a. as per key fact #5, some customers do not upgrade their XYZ software each year (meaning a Product PM update is not necessary for that customer and, in fact, could *create* an interoperability/compatibility issue); and
   b. not all XYZ software updates necessitate a Product PM update (so it is possible a customer only implemented an XYZ software version during the period that did not necessitate a Product PM update).

Based on the totality of the above facts, ABC concludes that its promises to transfer a Product PM term license and to provide co-terminus unspecified updates, upgrades and enhancements to Product PM are not separately identifiable; they are both integral to Customer receiving its intended benefit from the arrangement, which is continuous access throughout the license term to Product PM's complementary and interoperative functionality with XYZ's software. A failure of Product PM to be able to interoperate with XYZ's software effectively renders the Product PM license useless to the customer until such interoperability and compatibility are restored.

Question C175

If a software license and update rights are not distinct from each other, what is the effect of a renewal option for the update rights if the license and those initial rights are not co-terminus?

Interpretive response: Question C170 addresses when a software license and a right to unspecified updates, upgrades and enhancements ('update rights') are not distinct from each other, and therefore, are a single performance obligation.

It may be the case that this occurs when the software license is perpetual or for a term longer than the initial bundled update rights, and the contract grants the customer the option to renew the update rights. In those cases, unless the renewal option is priced commensurate with the price for the initial *bundled* offering, the renewal option generally provides the customer with a material right. Inherent in the conclusion that the license and the update rights are not distinct from each other is the premise that those update rights are integral to maintaining the utility of the software license and fulfilling the promise to the customer (e.g. of computer virus protection). Consequently, a renewal price for the update rights that is not substantially commensurate with the initial bundled offering price, reflective of the significant value one would ascribe to the integral update rights, would generally not be considered to reflect the stand-alone selling price for the renewed update rights.

A software entity that concludes that the renewal option(s) is (are) a material right(s) would allocate the transaction price of the contract for the initial bundled license/update rights to the performance obligations that were identified, i.e. (1) the combined performance obligation comprised of the license and initial update rights and (2) the material right(s). This would generally result in the software entity recognizing a significant portion of the transaction price of the initial contract (i.e. the portion allocated to the material right(s)) over future renewal periods of the update rights.

In contrast, if the renewal fee is substantially consistent with the initial, bundled price of the license and the update rights, it may be that no material right exists and, consistent with Question G40, exercising the renewal option would be accounted for as a separate contract from the initial contract for the bundled license/update rights.

Question C180

Are the considerations with respect to determining the performance obligations for promises of technical support and unspecified updates, upgrades and enhancements different in a SaaS arrangement and a software licensing arrangement?

Interpretive response: Questions C160 and C170, respectively, address whether technical support services and unspecified update/upgrade/enhancement rights and the related software license(s) are distinct from each other.

In general, there is no difference in the answers to these questions in the context of a SaaS arrangement. However, to some extent the 'distinct' analysis differs depending on whether the customer is accessing a dedicated instance of the SaaS provider's software (a 'single-tenant' architecture) or a shared instance of the software (a 'multi-tenant' architecture).

Single-tenant architecture vs multi-tenant architecture

A multi-tenant architecture is one in which a single instance of a hosted software application serves multiple customers. Each customer is called a tenant. Tenants may be given the ability to customize some parts of the application, such as color of the user interface (UI) or business rules, but they cannot customize the application's code.

In contrast, a single-tenant architecture is one in which only a single customer (or tenant) uses an instance of a hosted software application.

Multi-tenant environment

If the customer is accessing a multi-tenant SaaS environment, the customer is always accessing only the most current version and features of the software. The SaaS provider's updates, upgrades or enhancements of the hosted software do not fulfill a promise to a customer. Therefore, implementing those items into the multi-tenant instance of the software is *not* a promised service to any individual customer in the multi-tenant environment. This conclusion is further supported by the fact that the SaaS provider is generally continuing to update its multi-tenant environment for purposes of attracting prospective customers and encouraging existing customers to extend or renew their arrangements.

With respect to technical support obligations, we believe the considerations as to whether the SaaS and the technical support services are distinct would generally be consistent with the discussion in Question C160. However, because SaaS is provided over time, like the technical support services, rather than at a point in time like a software license, an entity may conclude that the SaaS and the technical support services can be accounted for as a single performance obligation if they are coterminous and have the same pattern of transfer to the customer.

It may frequently be concluded that both the SaaS and the technical support services are stand-ready obligations that have the same pattern of transfer to the customer – i.e. on a ratable basis. This conclusion is reached for the SaaS on the basis that the customer typically has equal access to the SaaS throughout the SaaS period, and for the technical support as described in Question C130.

Single-tenant environment

The considerations in a single-tenant environment will differ from a multi-tenant environment with respect to unspecified updates, upgrades and enhancements. This is because a promise to provide such items is fulfilled by specifically uploading them to the customer's single-tenant instance of the application. Because it is a single-tenant environment, the entity would be able to *not* provide those items to the specific customer, unlike in a multi-tenant environment. Therefore, the promise to provide unspecified updates, upgrades and enhancements would generally be considered a promised service to the single-tenant customer.

However, we believe the considerations about whether (1) the SaaS is distinct from the technical support and unspecified update, upgrade and enhancement rights; (2) whether the technical support is distinct from the unspecified update, upgrade and enhancement rights; and (3) whether any (or all) of those items can be combined because they are concurrently delivered and have the same pattern of transfer to the customer are consistent with the considerations outlined in Questions C150 – C170 and in the multi-tenant environment discussion above.

Question C190

Can a promise to provide technical support services or to provide unspecified updates, upgrades and enhancements be implied?

Interpretive response: Topic 606 states that a promise to provide a good or service may be implied by an entity's customary business practices. An implied obligation to provide technical support or unspecified updates, upgrades and enhancements exists in a contract if the entity has a historical pattern of regularly providing all customers or certain customers with technical support or unspecified updates, upgrades or enhancements (or anticipates doing so) even though there is no written contractual obligation.

One common scenario arises when the stipulated term of the explicit technical support and/or unspecified update/upgrade/enhancement period begins six months after transfer of control of the software license – e.g. the stipulated term may not begin until installation of the software is complete or until a general warranty period has expired. However, the entity has a history of regularly making available to all customers technical support or unspecified updates/upgrades/enhancements as soon as the license is transferred. In that scenario, there would be an implied (by the entity's customary business practice) promise to provide those services for the six months before the start of the explicit service period.

Comparison to legacy US GAAP

The determination of when an implied PCS obligation exists, and how to account for that implied obligation, is generally consistent between Topic 606 and legacy US GAAP. However, the different separation models under Subtopic 985-605 (e.g. the VSOE requirement) and Topic 606 means that the determination of whether the implied PCS obligation can be separated from other performance obligations in the contract (e.g. the software license) may differ between Topic 606 and legacy US GAAP.

With respect to the common scenario outlined above, the determination that an implied PCS obligation would exist under Topic 606 for the six-month period subsequent to software delivery, but before the commencement of the explicit PCS term, is consistent with legacy US GAAP. [985-605-55-53 – 55-55]

Question C200

If technical support services or unspecified update, upgrade and enhancement rights are mandatory, does that affect the conclusion about whether the software license and those services are distinct?

Mandatory PCS

Some software arrangements contain provisions that require the customer to renew PCS annually in order to maintain active use of a perpetual or a term license – i.e. the customer loses the right to use the software if it does not obtain or renew those services. In such arrangements, the customer is not only deciding whether to renew PCS each year, it is also deciding whether to renew the license.

The renewal payments after the initial PCS period in a mandatory PCS scenario apply to both the continued use of the license and the PCS renewal. Additionally, the fee for the initial period may be disproportionate to the fee for the renewal periods, even though the deliverables in each period are the same – e.g. in each period, the deliverables consist of a one-year software license bundled with one year of PCS.

For example, the fee for the license/PCS bundle in the first year may be $1,000,000, and the renewal fee for the license/PCS bundle in each subsequent year may be $150,000. In this fact pattern, the $850,000 delta between the $1,000,000 upfront fee for the license/PCS bundle and the renewal fee for the license/PCS bundle in each subsequent year of $150,000 could be deemed an incremental upfront payment that relates to the license/PCS bundle in the subsequent years.

Interpretive response: Example 11 Case D in Topic 606 makes it clear that the distinct evaluation for promised goods or services is based on an evaluation of the characteristics of the goods or services themselves, and a contractual requirement to obtain one or more of the goods or services (or to obtain one or more of the goods or services *from the entity*) does not affect that evaluation. Consequently, the distinct evaluation for a contract that includes *mandatory* technical support services or *mandatory* unspecified update, upgrade and enhancement rights is no different from the distinct evaluation undertaken for a contract for which those promised services are not mandatory (see Questions C160 and C170). [606-10-55-150E – 55-150F]

However, even though the mandatory nature of those services may not change the distinct analysis, it may affect the identification of the promised goods or services in the contract, and that analysis may differ depending on whether the software license is perpetual or term-based.

Term licenses

Consider a five-year term license that includes promised technical support services and unspecified update, upgrade and enhancement rights (collectively, PCS). If renewal of the PCS is mandatory throughout the license period (e.g. after an initial one-year term), that may change the parties' enforceable rights and obligations compared to the same arrangement for which renewal of those services is not mandatory. Depending on the facts and circumstances, the mandatory provision likely means that the contract includes only an initial one-year software license and one year of PCS, with *options* to renew *both* by paying the stated mandatory PCS renewal fee.

If the customer pays a significant upfront fee for the term license, such that the fees the customer will pay for the subsequent years' one-year license and PCS renewals are substantively lower than the fees paid for the license and the PCS in Year 1, payment of that upfront fee will provide the customer with a material right with respect to renewal of the in-substance one-year term license and PCS. Example C200.1 illustrates this scenario.

Perpetual licenses

Consider the same scenario described in the preceding paragraphs except that the five-year license is, instead, a perpetual license. Consistent with the above scenario, the mandatory PCS provision (1) likely means that the contract includes only an initial one-year software license and one year of PCS, with an *option* to renew *both* by paying the stated mandatory PCS renewal fee *and* (2) payment of a significant upfront fee likely provides the customer with a material right as to renewal of the one-year term license and PCS.

However, in addition, a portion (potentially significant) of the upfront fee will also relate to a material right to acquire a perpetual license once the mandatory PCS provision is satisfied. Example C200.2 illustrates this in a perpetual software license context.

It is possible in a perpetual license scenario that the mandatory PCS period lasts for all (or substantially all) of the economic life of the licensed software. For example, the software subject to a perpetual license has an economic life of 7 years and the customer is required to maintain PCS in order to retain its right to use the software for 7 years. In such cases, we do not believe any additional perpetual license right is granted in the contract. Therefore, the accounting would follow that described for term licenses.

License fee paid over time vs upfront

We do not believe the accounting for term or perpetual license mandatory PCS arrangements is affected by whether a legally enforceable license fee is paid upfront or over time. That is, the timing of payment for a license fee that is legally enforceable does not affect this analysis. However, in contrast, if the remainder of the license fee still owed by the customer subsequent to canceling PCS and losing the right to use the software is not legally enforceable, that would change the character of the overall contract. Example C200.3 illustrates a license fee paid over-time scenario.

Example C200.1

Software license and mandatory PCS (term license)

ABC Corp. enters into a contract with Customer to provide a five-year license to Product G and also to provide both technical support services and any updates, upgrades and enhancements developed (collectively, PCS) for one year. If Customer does not renew PCS each year of the five-year term it loses the right to use the software – i.e. there is a mandatory PCS provision in the contract.

ABC has determined that:

- it can account for its PCS as a single performance obligation (see Question C150); and
- the PCS, even though mandatory, is distinct from the Product G license.

Customer pays an upfront fee of $1,200,000 for the license and the first year of the mandatory PCS. The contract states that Customer must pay a fee of $200,000 each year to renew the mandatory PCS.

ABC concludes that the mandatory PCS provision means that the enforceable rights and obligations of the parties under the contract are for only a one-year term license to Product G and one year of PCS. Absent Customer deciding to renew PCS, Customer only has a right to a one-year license and to one year of PCS.

However, the significant upfront fee ($1.2 million) is substantially larger than the fee Customer would pay during the potential renewal periods ($200,000 per year in Years 2-5). Therefore, ABC concludes that the initial contract for Year 1 includes a material right with respect to Customer's options to renew the one-year license and PCS in Years 2-5.

ABC concludes that the Years 2-5 options provide Customer with a material right with respect to renewal of the license/PCS for Years 2-5. ABC reaches this conclusion based on the fact that allocating the upfront fee to each of Years 1-5 using the practical alternative in paragraph 606-10-55-45, which permits ABC to allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration ($2 million in total [$1.2 million in Year 1 + $200,000 per year for Years 2-5]), would result in an equal allocation of $400,000 to each of those years. Note that this analysis assumes that based on relevant experience with similar customers, no breakage is expected (i.e. Customer is expected to exercise all four renewal options).

ABC will therefore recognize $400,000 each year during Years 1-5 for the license and the PCS, with the portion allocable to the license each year recognized at the beginning of the renewal period (see Question F100) and the portion allocable to the PCS each year recognized over the one-year PCS period. As a consequence, a material right contract liability of $800,000 would be established at contract inception.

If Customer were to decide not to renew the contract for any of those optional years, the remaining amount of the contract liability for the material right (which would be $800,000 at the end of Year 1; $600,000 at the end of Year 2; $400,000 at the end of Year 3; and $200,000 at the end of Year 4) would be recognized as revenue at that point in time.

Example C200.2

Software license and mandatory PCS (perpetual license)

ABC Corp. enters into a contract with Customer to provide a perpetual license for Product H and also to provide both technical support services and any updates, upgrades and enhancements developed (collectively, PCS) for one year. If Customer does not renew PCS each year it loses the right to use the software – i.e. there is a mandatory PCS provision in the contract.

ABC has determined that:

— it can account for its PCS as a single performance obligation (see Question C150); and
— the PCS, even though mandatory, is distinct from the Product H license.

In addition, the following facts are relevant:

— the stand-alone selling price for a perpetual license to Product H is $2,000,000
— the stand-alone selling price for one year of ABC's PCS on a perpetual license at contract inception is $400,000
— the stand-alone selling price for a one-year license to Product H and co-terminus PCS on a one-year license (which are never sold separately from each other) is $600,000.
— the economic life of Product H is eight years.

Customer pays an upfront fee of $2,400,000 for the license and the first year of the mandatory PCS. The contract states that Customer must pay a fee of $400,000 each year to renew the mandatory PCS. After five years, Customer may choose not to renew the PCS, but retains its right to use Product H.

ABC concludes that the mandatory PCS provision means that the enforceable rights and obligations of the parties under the contract are for only a one-year term license to Product H and one year of PCS. Absent Customer deciding to renew PCS, Customer only has a right to a one-year license and to one year of PCS.

However, the upfront fee ($2.4 million) is substantially larger than the fee Customer would pay during the potential renewal periods ($400,000 per year in

Years 2-5). Therefore, ABC concludes that the initial contract for Year 1 includes a material right with respect to renewing the one-year license and related PCS for Years 2-4. In addition, ABC concludes that Customer is obtaining a material right to a perpetual license (bundled with one year of PCS) that it will control upon renewing PCS for Year 5. That is, upon accepting the option to renew PCS for Year 5 at the beginning of Year 5 (which includes accepting its obligation to pay the Year 5 PCS fee), Customer now controls a *perpetual* right to use Product H.

Consequently, at contract inception there are the following performance obligations in the contract:

— A one-year license to Product H
— One year of PCS related to Product H
— Material rights to obtain further one-year licenses to Product H and related PCS in each of Years 2-4
— A material right to obtain a perpetual license to Product H and one-year of related PCS at the beginning of Year 5.

The perpetual license to Product H that Customer may acquire at the beginning of Year 5 is not similar to the one-year term licenses Customer obtains initially and has the right to obtain in Years 2-4. Therefore, ABC cannot apply the practical alternative in paragraph 606-10-55-45; ABC must estimate the stand-alone selling price of the option to obtain a perpetual license to Product H. Various facts and circumstances, including the estimated stand-alone selling price of a perpetual license to Product H (which may be highly variable or uncertain) and consideration of breakage (i.e. the likelihood that Customer will forgo its material right by choosing not to renew PCS for Years 2-5), will affect the estimated stand-alone selling price of the perpetual license option.

Assume the following stand-alone selling prices are estimated for the material rights in the contract.

Option	**Discount**	**Probability of exercise**	**Stand-alone selling price**
Year 2 one-year license/PCS option	$200,000	98%	$196,000
Year 3 one-year license/PCS option	200,000	95%	190,000
Year 4 one-year license/PCS option	200,000	91%	182,000
Year 5 perpetual license/one-year of PCS option	$2,000,000	90%	$1,800,000

Consequently, the contract inception relative stand-alone selling price allocation is as follows (rounded to nearest dollar and tenth of a percent):

Performance Obligation	**Stand-alone selling price**	**Relative allocation %**	**Allocated amount**
Year 1 License/PCS	$600,000	20.2%	$485,175
Year 2 option	196,000	6.6%	158,490
Year 3 option	190,000	6.4%	153,639
Year 4 option	182,000	6.1%	147,170
Year 5 option	1,800,000	60.7%	1,455,526
	$2,968,000	100.0%	$2,400,000

The $485,175 allocated to Year 1 is then allocated between the license and the PCS based on the relative stand-alone selling price of each. ABC will recognize the portion allocated to the license at the beginning of Year 1 and recognize the portion allocated to the PCS over the one-year PCS period.

The amounts allocated to the options will remain deferred (i.e. as contract liabilities) until the respective option is exercised. When the option is exercised, the consideration for the additional license and PCS (e.g. the $400,000 fee applicable to Year 2) is added to the amount allocated to the Year 2 option for a total amount of consideration of $558,490. Consistent with the accounting for the license and PCS in Year 1, ABC will allocate the $558,490 between the license and PCS on a relative stand-alone selling price basis. ABC will recognize the portion allocated to the license at the beginning of Year 2 and recognize the portion allocated to the PCS over the one-year PCS period.

The accounting for Years 3-5 will generally be consistent with that for Year 2 other than with respect to the amounts recognized (due to the differing amounts allocated to the options).

Note:

The preceding two paragraphs assume that ABC accounts for the exercise of the Year 2 material right as a continuation of the existing contract. At the March 2015 TRG meeting, TRG members generally agreed that it would also be acceptable for an entity to account for the exercise of a material right as a contract modification (see TRG Agenda Papers Nos. 32 and 34). That 'contract modification' approach would result in different accounting from that outlined in the preceding paragraphs as it would generally account for each exercise of one of the options in the contract as a termination of the existing contract and the creation of a new contract. For purposes of this example, we have not illustrated the results of that approach.

Example C200.3

Software license and mandatory PCS – license fee paid over time

Scenario 1: Entire license fee is legally enforceable if Customer cancels PCS

ABC Corp. enters into a contract with Customer to provide a three-year license to Product T and also to provide both technical support services and any updates, upgrades and enhancements developed (collectively, PCS) for one year. If Customer does not renew PCS for Years 2 and 3 it loses the right to use the software – i.e. there is a mandatory PCS provision in the contract. Under the terms of the contract, Customer pays the $300,000 license fee in three equal installments of $100,000 at the beginning of each year of the license term. PCS is $60,000 each year, payable in advance. Customer has a legally enforceable obligation to pay the entire $300,000 license fee even if it chooses not to renew PCS in either Year 2 or Year 3 (note: even if ABC has a history of not enforcing remaining license fee installments if the PCS is not renewed, ABC may still have an enforceable right to such fees – see Question B140). The stand-alone selling price for ABC's PCS on term licenses at contract inception is $60,000.

ABC determines that the one-year PCS service is a single performance obligation (see Question C150) and is distinct from the license to Product T. Despite the fact the license fee is paid over time, rather than upfront, the conclusion in this scenario is consistent with that in Example C200.1. This is because the license fee is legally enforceable regardless of whether Customer renews PCS; therefore, the timing of payment of the license fee alone does not change the accounting from that outlined in Example C200.1, with the exception that there may be a significant financing component in the contract as a result of Customer paying for the license to Product T over time (see *Chapter D – Step 3: Determine the transaction price*).

Scenario 2: The unpaid portion of the license fee is no longer owed if Customer cancels PCS

Assume the same facts as in Scenario 1 except that if Customer does not renew PCS for Year 2 or Year 3, the remaining balance of the license fee is no longer owed by Customer.

In this case, the substance of the contract is a one-year term license with co-terminus PCS. Customer, in effect, has an option each year to renew both the license and the PCS for another year. Consequently, the transaction price at contract inception is only the enforceable $160,000 ($100,000 Year 1 license payment + $60,000 Year 1 PCS payment). Consistent with Scenario 1, ABC determines that the PCS is a single performance obligation that is distinct from the one-year license to Product T. Consequently, ABC recognizes the portion of that $160,000 transaction price allocable to the Product T license at the beginning of the one-year term (which is when Customer obtains control of the license) and the portion allocable to the PCS over the one-year term using an appropriate measure of progress (see Question C130).

ABC's accounting for the contract in Years 2 and 3 will, absent any modification to the contract, be consistent with that for Year 1.

Comparison to legacy US GAAP

Under legacy US GAAP, the contract could be characterized as a perpetual license or a multi-year time-based license (i.e. the contract may be worded/structured in such manner). This is because the customer loses the continued right to use the software if PCS is not renewed, so in substance the arrangement was considered to be a series of one-year time-based licenses bundled with annual PCS.

Because the renewal payments after the initial one-year PCS period in a mandatory PCS scenario apply to both the continued use of the license and the PCS renewal, the entity did not have a separate renewal rate for PCS. Therefore, the entity could not establish VSOE of fair value for PCS and could not separate the one-year time-based license from the one-year PCS.

As a result, in practice, either of the following accounting policies were considered acceptable alternatives to account for the amounts received in the initial term of the arrangement.

— Recognize the entire initial fee for the license/PCS bundle over the initial term, provided such term was considered substantive, and recognize renewal fees in subsequent years over the respective renewal periods.

— Defer and amortize the incremental portion of the initial fee for the license/PCS bundle (i.e. the amount of the initial fee that was greater than the stated renewal period fee) over the estimated term of the arrangement. If the term of the arrangement was not determinable, then the incremental portion of the initial fee was deferred and amortized over the economic life of the software product. If the customer elected not to renew PCS in a future period, any remaining deferred revenue was recognized at that time.

The accounting model for mandatory PCS arrangements outlined in the Question will represent a significant change for most entities with these arrangements from the accounting under legacy US GAAP.

Question C210

If a customer reinstates technical support and/or unspecified update, upgrade and enhancement rights after allowing them to lapse, are those services distinct from any promises to provide updated or enhanced software (i.e. releases the customer did not get during the lapse) as part of the reinstatement?

Reinstated PCS

For perpetual or time-based licensing arrangements in which the customer has canceled PCS (or allowed PCS to lapse), entities frequently charge an additional fee to customers who wish to reinstate the PCS arrangement.

In certain circumstances, the customer will receive previously released upgrades or enhancements upon reinstatement of an inactive PCS arrangement. Contractual provisions requiring incremental fees to reinstate a PCS arrangement that has lapsed are common in the software industry. Such fees may be in the form of a penalty or they may be equivalent to the actual PCS fees that would have been charged had the customer remained a current PCS subscriber (i.e. back PCS).

In addition, there may be circumstances where the entity offers an amnesty program to persuade customers to reinstate the PCS that has elapsed under the arrangement. Under such a program, upon reinstatement of the inactive PCS the entity may offer to waive a portion or all of the previously released upgrades or enhancements and any penalties that may be due contractually under the arrangement. Upon reinstatement of the PCS, such arrangement would be accounted for as a concession because a substantive incremental payment was waived by the entity. However, we believe that an amnesty program that is offered once to all its customers is more akin to a sales incentive and generally does not establish a history of concessions.

Interpretive response: The characterization of the contract as one for a 'reinstatement' of PCS or otherwise does not matter. Such an arrangement, however characterized, is no different from any other new contract for one or more specified software licenses (e.g. an upgrade to Version 3.0 and provision of an enhancement in the form of a new module), technical support services and a right to future unspecified updates, upgrades and enhancements.

Regardless of whether the entity does or does not charge a 'reinstatement fee', or the amount of any such fee, the entity allocates a portion of the transaction price to any previously released upgrades or enhancements the customer will specifically receive as part of the arrangement – i.e. those are specified upgrades or enhancements. This might result in the entity recognizing a contract asset if there are no fees paid by the customer under the reinstatement, or if those fees are less than the transaction price allocated to those items, at the time the previously released upgrades or enhancements are transferred to the customer.

The considerations to determine whether any specified software licenses or upgrades, technical support services and unspecified update/upgrade/enhancement rights are distinct in this context are consistent with those outlined in Questions C150 – C170.

If, at contract inception, (1) there is a reasonable expectation that the customer will cancel PCS and later reinstate PCS and (2) the entity has a pattern (i.e. customary business practice) of providing previously released updates, upgrades and enhancements without charging a substantive incremental fee upon PCS reinstatement, this may result in a conclusion that the customer's payment of the current contract fees also provides the customer with a material right to previously released updates, upgrades and enhancements upon reinstatement of PCS in the future. Therefore, entities may want to ensure that in PCS reinstatement scenarios they charge a substantive fee for previously released updates, upgrades and enhancements to avoid evaluating, and potentially accounting for, a material right.

Comparison to legacy US GAAP

Under legacy US GAAP, the appropriate revenue recognition treatment for a transaction to reinstate an inactive PCS arrangement depended on whether the renewal transaction involved multiple elements.

When a customer received previously released upgrades upon reinstatement of an inactive PCS arrangement, the reinstatement arrangement was equivalent to a multiple-element transaction to purchase software upgrades and PCS from the date of reinstatement.

When VSOE existed for the go-forward PCS but not for the software elements, which may include new software licenses as well as previously released upgrades or enhancements, the residual method was applied to assign the arrangement consideration to the elements of the arrangement. Application of the residual method could result in the recognition of all or a portion of the PCS reinstatement fee upon delivery of the software element(s).

However, it was generally not appropriate to recognize revenue upfront in a single-element PCS reinstatement arrangement where (1) the customer was not entitled to receive upgrades or enhancements previously provided to active PCS subscribers or (2) the customer was entitled to receive upgrades or enhancements previously provided to active PCS subscribers, but no upgrades or enhancements were released during the period(s) in which the customer's PCS was inactive. Instead, when a PCS renewal arrangement did not involve multiple elements, any reinstatement fee charged at inception of the PCS renewal, regardless of form, was ascribed to the future PCS services. It was not deemed appropriate to recognize the PCS reinstatement fee upon renewal in those situations because the reinstatement itself did not constitute a separate deliverable of the arrangement, even if the related agreements state that the fee is attributable to PCS for prior periods.

In general, the accounting for PCS reinstatements will not be significantly different under Topic 606, with the following exceptions.

— The amounts allocated to the various elements in a multiple-element reinstatement may differ because of the changes in the transaction price measurement and allocation guidance (see *Chapter D – Step 3: Determine the transaction price* and *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*).

— Under legacy US GAAP, if the reinstatement included rights to previously released updates, upgrades or enhancements, and a commensurate fee was not charged for those items, provision thereof was treated as a concession to the customer. No revenue was recognized upon delivery of those upgrades or enhancements if any payments to be received from the customer were contingent on future performance. Under Topic 606, revenue will generally be recognized upon transfer of the previously released upgrades and enhancements, even if all of the consideration in the contract is contingent on the provision of future PCS. As noted in the question, the consideration in the contract for the reinstated PCS may include consideration from a previous contract deferred as a material right to receive the previously released updates, upgrades or enhancements for free or at a significant discount.

Professional services

Software and SaaS contracts frequently include professional services. For purposes of evaluating whether professional services sold in a contract with one or more software licenses, and potentially additional goods or services such as PCS or hosting services or specified software upgrades, the basic categories of professional services need to be understood.

In general, the following are the principal types of professional services that may be included in a bundled software arrangement:

— **Implementation services.** Software implementation generally includes tasks such as (not exhaustive): software selection, defining software requirements, implementation planning, system architecture and network planning, software installation, software and systems integration and interfacing, testing of the installed software/system, post-deployment review.

Implementation services are often available from the software vendor providing the license(s), as well as from alternate providers. Implementation service can also, typically, be at least partially performed by the customer's in-house personnel.

Software implementation services can range from being non-complex to significantly complex. Often the level of complexity of the implementation services determines whether parties other than the entity can perform all or a significant portion of the services. However, in some cases, there are sophisticated service providers that can provide even extremely complex implementation services, including services that require access to the software code – e.g. if the service provider has an access permission agreement with the software provider.

— **Configuration services.** Configuration refers to how a system is set up, or the assortment of components that make up the system. With respect to software, typical configuration services relate to the setting of various 'flags' or 'switches' within the software, or defining certain values or parameters, to implement a particular set-up for the software's existing functionality. Configuration does not involve the modification or writing of additional software code, but rather involves setting up the software's existing code to function in a particular way.

— **Customization services.** A software vendor or another service provider provides customization services that typically involve modifying existing software code in the application or writing additional code. The effect of significantly altering or adding software code is generally to change, or create additional, functionalities within the software.

— **Training services.** Software vendors and other service providers often offer their customers services to train their personnel on the use of, and in some cases how to provide at least first-tier support for, licensed or purchased software.

— **Other consulting services.** Software vendors and other consulting firms and service providers may provide a variety of 'other' services that may not be directly linked to a specific software application.

SaaS arrangements also frequently include professional services. Many of the services SaaS providers offer are similar to those provided for on-premise software solutions. For example, implementation services in SaaS arrangements will frequently include configuration and/or interfacing, data migration/conversion, user acceptance testing and end-user training. Customization of the SaaS (e.g. developing additional functionalities) may also occur in some cases.

Question C220

What should a SaaS provider consider in evaluating if upfront services it provides in a SaaS arrangement are a promised service or solely an administrative task/set-up activity that does not transfer a good or service to the customer?

Interpretive response: Set-up activities, as opposed to promised services, provide no incremental benefit to the customer beyond that which they will receive from access to the hosted application. In other words, set-up activities represent those tasks that are *necessary* for the customer to begin to use and benefit from the hosted application. For example, a SaaS provider may perform tasks that range from simple activation activities necessary for the customer to access the web-based software application to more complex upfront activities needed to allow the customer to access the SaaS services from the customer's IT platform. In either case, those tasks represent activities that are necessary solely for the customer to access and begin to use the hosted application.

In contrast, promised services provide some measure of benefit *beyond* that of solely being able to access and use the hosted software application. Examples of promised services include: assisting the customer in interfacing their existing operating software (e.g. an ERP system) with the hosted software application, performing customer-specific configuration services so that the software will operate most effectively in the customer's business environment, providing training services to permit the customer to use the application effectively, and performing data migration/conversion services related to the customer's existing data that the customer would otherwise have to perform itself (or obtain from a third party).

If another entity provides the services in question (e.g. a consulting services entity provides data conversion/migration), we would generally expect those would be promised services when provided by the software entity, rather than set-up activities. However, the fact that another entity does not provide those services is not determinative that they are set-up activities when performed by the software entity.

Example C220.1

Set-up activities vs implementation services in a SaaS arrangement

ABC Corp. enters into a contract to provide Customer with access to its SaaS for three years.

As part of the contract, before commencement of the SaaS term, ABC will set up the user interface that Customer will need to access the online application, and will also undertake data conversion and migration activities for Customer to configure and move its relevant, existing data from Customer's current on-premise solution to ABC's hosted environment. ABC will also provide training to relevant Customer personnel on use of ABC's hosted application.

ABC evaluates each of the activities it agrees to undertake as part of the contract: the set-up of the user interface, data conversion and migration activities, and training of Customer's personnel.

ABC concludes that set-up of the user interface is a set-up activity, rather than a promised service to Customer. It provides no *incremental* benefit to Customer beyond permitting Customer to access and use the hosted application.

In contrast, the data conversion and migration activities, and the training of Customer's personnel, are services that will provide Customer with incremental benefits beyond just the ability to access and use the hosted application. The data conversion and migration activities ABC will perform would otherwise need to be performed by Customer or another service provider and, even though it would be inefficient, Customer would be able to use the hosted application for new transactions without converting and migrating its old data. The training of Customer's personnel will permit Customer to effectively use ABC's hosted application. In both cases, the data conversion/migration and the training, ABC's activities are doing more than simply setting up or enabling Customer to access and use the SaaS.

Question C230

How should an entity evaluate whether professional services to significantly customize or modify the licensed software are distinct from the associated software license?

Interpretive response: Professional services provided in a software licensing arrangement can vary greatly from contract to contract; therefore, the contract-specific facts and circumstances should always be considered. However, in general, a software license and professional services to significantly modify or customize that software for the customer's use will comprise a single performance obligation, as will an entity's services to produce a new software application for a customer and grant a license thereto. The basis for that conclusion is likely to differ depending on whether the nature of the arrangement is customizing or modifying an existing software product for the customer or producing new software.

New software production

A production scenario entails the development of a new, customized software product for a customer. The customer cannot use and benefit from the license to the customized software product until the development is complete – i.e. control of the software license does not transfer until the development is complete.

This ordering of how the license and the associated services are transferred to the customer affects the assessment of whether those items are capable of being distinct. The license is not transferred before the performance of the development services and is, by nature of it being a new, customized software product, not licensed separately by the entity. Therefore, the development services do not provide benefit to the customer on their own or with any *then-readily available* resource.

Because the development services are not capable of being distinct, the development services are combined with the license to the developed software that will be transferred to the customer upon completion of the development services into a single performance obligation.

Customizing or modifying an existing software product

In a modification/customization scenario, if the customer obtains the right to use and benefit from the underlying software (i.e. is granted the license to use the software that will be modified/customized by the entity's services), the software license and the customization services will typically be capable of being distinct. This is because the customer can benefit from the:

— underlying software on its own or together with other readily available resources (see Question C110); and
— customization services together with the delivered license to the underlying software.

However, in a software contract that includes professional services that significantly modify or customize the customer's instance of the software, the entity's promise to transfer the software license and its promise to provide the professional services will typically *not* be separately identifiable. This is because:

— the underlying software and the customization services are inputs to the combined output (i.e. the customized software) for which the customer has contracted, such that the entity is providing a significant integration service of combining those inputs into that combined output; and

— the customization services are significantly modifying and/or customizing the software license.

The separately identifiable evaluation will generally not be affected by whether another entity could provide the professional services. This is because that would not affect whether the entity is providing a significant integration service *in this contract* or that the professional services are significantly modifying and/or customizing the software license.

Comparison to legacy US GAAP

Legacy Subtopic 985-605 specified that if a software arrangement required significant production, modification or customization of the software, the entire arrangement was accounted for using contract accounting. This is because, in an arrangement that involved significant production, modification or customization of the licensed software, the service element is essential to the functionality of the software.

Therefore, the conclusion that a software license and services to produce, modify or customize the licensed software will generally constitute a single performance obligation under Topic 606 is consistent with the unit of account conclusion under legacy US GAAP for those same elements. Questions F200 and F260, respectively, discuss whether a single performance obligation comprised of a software license and significant customization services is satisfied over time or at a point in time and appropriate measures of progress to apply (i.e. timing of revenue recognition) if the performance obligation is satisfied over time.

Example C230.1
Software license and customization services

ABC Corp. licenses trust asset management system software called Product B. The Product B software enables users, typically large financial institutions, to access and value individual US dollar denominated trust account portfolios on a real-time basis. Product B functions as designed without any customization or modification services and can be implemented without ABC's assistance in most cases.

ABC entered into a specific contract with Customer, a large bank, to grant a license to the Product B software and to provide services to modify the customer's instance of the software. This includes modification of the software code and configuration of certain modified and off-the-shelf settings to allow Customer to access and value its trust account portfolios in multiple foreign currencies in addition to US dollars. The modification and configuration significantly affect the Customer's ability to use the Product B software as it intends. ABC expects that it will take approximately 18 months to perform the services.

ABC concludes that there are two promised goods and services in this contract: the software license, and the professional services to customize and configure the software.

In this example, the software license and the professional services are each capable of being distinct. Customer could derive benefit from the license for Product B on its own or with readily available implementation services. Customer can benefit from the professional services together with the license to Product B that is transferred at contract inception.

However, ABC determines that the promises to transfer a license to Product B and to provide the associated professional services are not separately identifiable in the context of the contract – i.e. there is a single performance obligation. This is because:

— Product B in its off-the-shelf form and the professional services to be applied to that software to modify the software code and effect the required configuration are both inputs to the combined output the customer has contracted for (i.e. the customized software).

— The professional services will significantly modify and customize the customer's instance of the Product B software. Note that the configuration aspect of the professional services does not modify or customize the software because these services merely configure functionality that already exists in the software code; no software code is modified or additionally written.

Question C240

How should an entity evaluate whether implementation and installation-type services are distinct from the associated software license?

Interpretive response: The nature and extent of professional services provided in a software licensing arrangement can vary greatly from contract to contract; therefore, the contract-specific facts and circumstances should always be considered. However, in general, a software license and related professional services that are principally implementation in nature and that are not complex will be distinct from each other; therefore, they are separate performance obligations.

Question C260 discusses additional considerations with respect to more complex implementation services.

Provide benefit on their own or together with other readily available resources

Implementation services do not significantly change the functionality of the software – i.e. implementation services do not involve changing or appending software code. Therefore, entities will typically conclude that:

— the software provides benefit to the customer on its own or together with other implementation services generally available from alternate providers; but
— the services provide benefit to the customer together with the software license that is generally transferred upfront.

In some arrangements, the license term does not begin until the implementation services are completed. In that case, the license is not transferred to the customer until *after* the implementation services are completed because the customer is not able to use and benefit from the software until the license term commences (see Question F30).

However, even in that circumstance, the customer can benefit from the implementation services together with a 'readily available resource' if the entity sells licenses to the software separately. The software license is a readily available resource if the entity either sells licenses to customers without implementation services or sells renewal licenses to customers separately. This is because a readily available resource is defined as 'a good or service that is sold separately (by the entity or another entity)'. [606-10-25-20]

As a further observation, even if the entity only sells those licenses together with PCS, such that it does not sell the software license separately, the bundle containing the license and the PCS can be the readily available resource with which the customer can benefit from the implementation services.

Separately identifiable from other promises in the contract

An entity's promises to transfer a software license and to provide professional services that do not significantly modify or customize (i.e. change) the licensed software will typically be separately identifiable. Because implementation services do not modify or customize the licensed software, the software license and the implementation services are not inputs to a combined output. Rather, the implementation services are applied *to* the licensed software; therefore, the entity is not providing a significant integration service.

Further, the software license and implementation services typically will not *each significantly affect the other*, and therefore are not highly interrelated or interdependent in this contract. While the implementation services necessarily depend on the transfer of the software license – i.e. the customer can only benefit from the services after it has obtained the software license – in general, the implementation services do not significantly affect the software license. The entity will be able to fulfill its promise to transfer the software license independently of its promise to provide the implementation services. That is, because the licensed software will not be changed by the entity's services, when (or whether) it performs the implementation services does not affect the entity's ability to fulfill its promise to transfer the software license.

Example C240.1
Software and implementation services

ABC Corp. licenses Software Product A to Customer on a perpetual basis along with specified implementation services. The implementation services consist of developing non-complex interfaces, performing data conversion and migration, loading/installing the software, and running test data. Product A can be used by the customer upon basic installation without any significant customization or ABC providing the specified implementation services.

Due to the magnitude of global operations of Customer, the implementation services are expected to take 12-15 months to complete. The stated fees for the implementation services exceed the fees attributable to the Product A license. ABC is an experienced provider of implementation services for Product A and has a history of successfully providing services of this nature to the satisfaction of customers. The services do not carry a significant degree of risk or unique acceptance criteria. Customer is expected to assign internal IT personnel to work closely with ABC on the implementation effort, including project management.

ABC concludes that the software license to Product A and the implementation services (which are determined to be a single performance obligation in this contract – see Question C250) are each capable of being distinct.

The Product A software is fully functional to its off-the-shelf specifications as soon as it is installed in Customer's IT environment. This means that Customer is able to benefit from the software either on its own (if its own personnel could install the Product A software) or together with basic installation services that are readily available from numerous alternate providers.

Customer can benefit from the implementation services together with the software license transferred upfront.

ABC also concludes that its promises to transfer the Product A license and to provide the implementation services are separately identifiable. This is because the implementation services are not significantly modifying or customizing the software; the off-the-shelf software and ABC's services are, in effect, each outputs of this contract rather than inputs to a combined output of the contract.

ABC determines that, because the contracted services will not change the licensed software (i.e. modify or customize the software code), the services do not significantly affect the software license such that ABC would be unable to fulfill its promise to transfer the software license independently from fulfilling its promise to implement that software. Consequently, the services and the license are not highly interrelated or interdependent in this contract.

Because the Product A license and the implementation services are distinct from each other in this contract, the license and the services are separate performance obligations.

Question C250

If an entity provides multiple implementation services, are each of those services a separate performance obligation?

Interpretive response: What entities consider to be 'implementation services' may actually encompass a number of services that would each be distinct. Examples include the loading of software, data conversion and migration, building interfaces and end-user acceptance testing.

For example, an entity's services to convert and migrate customer data to its software may be distinct from its services to build certain interfaces or provide training to customer personnel; each of those services may be able to be fulfilled, and provide benefit to the customer, independently, such that they are separate performance obligations.

However, it may frequently be the case that either:

— the various implementation services will be provided over the same implementation period and have the same pattern of transfer to the customer – e.g. the entity may use a cost-to-cost or labor hours input method to measure progress toward the satisfaction of each promised service; or

— the service will not be provided concurrently, *but* the measure of progress for each service is the same and there would be a consistent transaction price allocation between each service – e.g. because the entity's stand-alone selling price for its professional services is its observable hourly rate, which is consistent between the services.

In either case, the entity is permitted to account for the multiple services as a single performance obligation because the accounting outcome should be the same as accounting for those services as separate performance obligations.
[ASU 2014-09.BC116]

Question C260

How does an entity evaluate whether implementation services that are complex, but do not significantly customize or modify the software, are distinct from the associated software license?

Interpretive response: Implementation services that consist principally of tasks or activities such as implementation planning, loading of software, training of customer personnel, data conversion or migration, building simple interfaces, running test data, user acceptance testing, and assisting in the development and documentation of procedures are not generally considered 'complex'. Question C240 addresses whether non-complex implementation services are distinct from the associated software license(s).

What constitutes complex implementation services will be a matter of judgment, but we believe such services include tasks such as developing complex interfaces and would generally take more time to complete than those of a simple nature. The complexity of the implementation services might be further evidenced if the customer's personnel or other service providers could not perform significant portions of the services.

Distinguishing complex interfaces from those of a simple nature will require judgment because there is no standard definition of a 'complex interface'. Over time, practice has developed whereby a number of factors are assessed in attempting to delineate simple from complex interfaces. We believe that the following factors are relevant to identifying complex interfaces and being able to apply Topic 606's separation model to services that include the building of such interfaces. This list is not exhaustive, and the presence or absence of one of the factors would not necessarily be conclusive of whether requested interfaces are complex.

— **The time and effort to complete the interfaces.** If the building of the requested interfaces will take a substantial amount of time and/or extensive effort to complete, this indicates a greater level of complexity.

— **Whether another provider or in-house customer personnel could complete the interfaces.** If another service provider or the customer's in-house IT personnel could not complete (or substantially complete) the interfaces (e.g. because it requires access to the software's source code), this indicates a greater level of complexity. The evaluation of this factor is not affected by any contractual restrictions – e.g. any restriction in the contract prohibiting the customer from using an alternate provider.

— **Whether there is a significant level of risk in successfully completing the interfaces.** If there is a significant level of uncertainty with respect to the entity's ability to complete the interfaces (which may be evidenced by the contract's payment terms or acceptance, termination or cancellation provisions), this would suggest that the requested interfaces are of a more complex nature.

Capable of being distinct

The evaluation of complex implementation services will require judgment. However, we believe a software license and even complex implementation services will generally be capable of being distinct for the same reasons outlined in Question C240 (implementation services in general).

Separately identifiable

We expect that an entity's promise to transfer a software license and provide even complex implementation services will be separately identifiable in most cases. The analysis leading to that conclusion will likely be consistent with that outlined in Question C240. This is because even complex implementation services are not modifying or customizing the licensed software (i.e. changing or appending the software code) or vice versa, and the license and the services do not *each* significantly affect the other – i.e. while the services necessarily depend upon the license, in general, the entity can fulfill its obligation to transfer the software license independently of fulfilling its obligation to provide the services (e.g. build complex interfaces).

However, in more limited circumstances, an entity may conclude that the entity's promise to provide complex implementation services is not separately identifiable from its promise to transfer the software license(s) in the contract. Consider the following:

— In some contracts, the entity may be providing a significant integration service (as described in paragraph 606-10-25-21(a)), using the licensed software and those interfaces as inputs to produce a 'solution' that is the combined output the customer entered into the contract to obtain. This might be the case if the act of interfacing the licensed software and the software/systems with which the licensed software will interface will create combined functionality – i.e. functionality that is dependent on both the licensed software (e.g. Product A) and the other software with which the licensed software is interfaced (e.g. Product B). The situation described in this bullet point does *not* refer to a situation in which one (or both) applications/systems merely 'feeds' the other (e.g. supplies data to the other); rather, it refers to a situation in which the interfaces permit the two applications, together, to perform additional functions or tasks that neither can perform individually. That is, the interface(s) permit Product A and Product B to perform additional functions or tasks that cannot be performed by either software application separately. The analysis in this regard is substantially similar to that outlined in Question C120 for determining whether two promised software licenses are distinct from each other.

— The basis for conclusions to ASU 2016-10 states that the principle of determining whether two promises are separately identifiable considers whether the customer's ability to derive its intended benefit from the contract depends on the entity fulfilling *both* promises. There may be circumstances in which complex implementation services are so integral to the customer's ability to derive benefit from the software license that the software license and the services are effectively inputs to a single promise to the customer. [ASU 2016-10.BC33(b)]

  For example, if *complex* interfacing (or a specialized configuration of the software) is necessary for the customer to derive its intended benefit from the software within the context of the contract *and no other entity can perform those services* (e.g. because the services rely upon proprietary knowledge of, or access to, the software source code), that may result in a conclusion that the software license and the implementation services are a single performance obligation.

We believe that no other entity (including the customer) being *capable* of performing the necessary services is required in order to reach the conclusion in the preceding paragraph. If the customer could obtain the necessary services from another entity (regardless of any contractual restrictions requiring the customer to obtain the services from the entity), that would mean the *entity's* promise to provide the services is *not* integral to the customer's ability to derive its intended benefit from the software license.

Example C260.1

Software license and complex implementation services (complex interfacing)

ABC Corp. licenses investment portfolio management software (Product C). Typically, a customer can use the Product C software upon installation with little or no customization. ABC entered into a contract with Customer, a large international bank. Customer has numerous branches and subsidiaries around the world and wishes to centralize its investment function. The branches and subsidiaries of Customer operate using various hardware and operating software.

As part of the arrangement with Customer, ABC agrees to license the Product C software to Customer and to provide services to build interfaces that will allow Product C to interface with the various hardware and operating software used by Customer's branches and subsidiaries, and with Customer's current general-ledger software. It is clear to ABC from the negotiation and contract drafting process that Customer would view the Product C license as having relatively limited value without the ability to use it across its many branches and subsidiaries and being able to interface Product C with its general ledger software.

ABC estimates that it will take approximately one year to complete the interfaces, at which time the Product C software will be fully functional in all of Customer's branches and subsidiaries. There are no other service providers that have the requisite expertise to build these interfaces because of the complex nature of the Product C software; and Customer does not have the requisite expertise in-house.

ABC concludes that there are two promised goods and services in this contract: the Product C license, and the implementation services. ABC concludes that it is providing complex implementation services given the nature of the requested interfacing; this is because no other party could build the interfaces, and because of the amount of time and level of effort it will take to complete the work.

As the first step in its separation analysis, ABC concludes that the Product C license and the complex implementation services are capable of being distinct because each is capable of providing benefit to Customer either on its own or together with other readily available resources. Customer can derive benefit from the Product C license together with readily available installation services (basic installation services would be internally available or available from other service providers) and can derive benefit from the complex implementation services together with the license to Product C that is transferred at contract inception.

Next, ABC analyzes whether its promises to transfer the license to Product C and to provide the implementation services are separately identifiable. In the first instance, ABC considers the following two factors from paragraph 606-10-25-21, which support a view that those promises are separately identifiable.

— While ABC's services to develop interfaces for Customer are an important component of the contract, the development of the interfaces will not result in new or combined functionalities that rely on Product C and Customer's existing systems. Consequently, Product C and the implementation services are not inputs to a combined output and ABC is not providing a significant integration service in this contract.

— The implementation services will not significantly modify or customize the customer's licensed instance of Product C or vice versa. This fact also further supports that the Product C license and ABC's implementation services are not inputs to a combined output sought by Customer.

Despite the evidence suggested by those factors, ABC concludes that its promise to transfer the Product C license and its promise to provide the implementation services in this contract are not separately identifiable. This is because, within the context of this contract, the Product C license and the implementation services ABC will provide are both integral to delivering Customer's desired output from this contract – i.e. the ability to use Product C across its global network of branches and subsidiaries – and no other vendor can provide the complex implementation services. The benefit Customer would be able to derive from the Product C license alone – i.e. without the implementation services – is significantly limited as compared to Customer's objectives when entering into the contract (as understood by ABC through the negotiation and sales process); and Customer is unable to perform the implementation services itself or obtain those services from any other entity besides ABC. Meanwhile, the benefit Customer would be able to derive from the implementation services would be nil without the Product C license.

Consequently, the nature of ABC's overall promise to Customer is to provide an appropriately interfaced software solution (i.e. the combined item) to which the base Product C license and its implementation services are inputs.

Because ABC's promises to transfer the Product C license and to provide the implementation services are not separately identifiable, they are not distinct and comprise a single performance obligation.

Comparison to legacy US GAAP

Legacy Subtopic 985-605 did not provide explicit guidance for determining if services to build complex interfaces that are necessary for the off-the-shelf software to be functional in the customer's environment would result in contract accounting for the arrangement. However, during the deliberations of the legacy US GAAP literature, some members of the Accounting Standards Executive Committee (AcSEC) of the AICPA expressed the view that services that entail building interfaces to enable off-the-shelf software to function in the customer's environment generally would not be considered essential to the functionality of the software unless the interfaces are very complex. As a result of that observation, practice developed whereby services to build complex interfaces were determined to be essential to the functionality of the software. Therefore, the software license and those services were accounted for as a single contract accounting unit.

For the reasons outlined above, we do not believe entities should account for a software license and services that entail complex interfacing as a single performance obligation in all cases under Topic 606. Therefore, it is possible that some entities will come to different conclusions about the separability of a software license and services to build complex interfaces under Topic 606 than they did under legacy US GAAP.

Question C270

Are there instances where configuration services, not accompanied by customization services, would not be distinct from the associated software license?

Interpretive response: In general, a software license and associated configuration services will be separate performance obligations.

A software license for off-the-shelf software is generally capable of being distinct (see Question C110), while the configuration services are capable of being distinct together with the software license that is generally transferred upfront.

Configuration services do not modify or customize (i.e. change) software, but merely set the parameters for how existing functionalities already written into the software code will function – e.g. if a software application has the ability to round numbers, a configuration task may be to set its default rounding to three decimal points, rather than two or four. Because configuration services do not modify the software code, a promise to transfer a software license and a promise to provide configuration services will typically be separately identifiable.

This is supported by an evaluation of the factors in paragraph 606-10-25-21.

- As noted above, neither the software license nor the configuration service significantly modify or customize the other.
- Because the configuration services do not modify the licensed software, the entity is generally *not* providing a significant integration service; this is notwithstanding that, in a purely literal sense, the existing software and the services are both inputs to the configured output that the customer will use. Rather it is applying its configuration services *to* the existing software – i.e. in contrast to, for example, using the software and *customization* services as two inputs to produce significantly modified software.

— Consistent with the discussion of non-complex implementation services (see Question C240), we believe that where professional services will not modify the licensed software, those services do not significantly affect the software license. Therefore, because the software license and the services do not *each significantly affect the other*, they are not highly interrelated or interdependent.

However, consistent in principle with the discussion of complex implementation services in Question C260, we believe that in more limited circumstances an entity's promise to provide configuration services may not be separately identifiable from its promise to transfer the associated software license. This is the case when specialized configuration services both:

— *are integral* (i.e. fundamental) to the customer's ability to derive its intended benefit from the software license – see discussion of 'integral' in Question C260; and [ASU 2016-10.BC33(b)]
— *cannot be performed by another entity* (e.g. because the services rely upon proprietary knowledge of, or access to, the software code). Contractual restrictions requiring the customer to obtain the services from the entity are not considered in making this assessment.

In that case, the software license and the configuration services would be a single performance obligation.

Question C280

Are the considerations for a SaaS provider different from the considerations for an entity licensing software when determining whether professional services are distinct from the SaaS?

Interpretive response: Question C220 discusses whether upfront activities performed by the SaaS provider in a SaaS arrangement are determined to transfer a promised service to the customer.

In most cases, the SaaS provider's considerations will be similar to those of an entity that licenses software; however, potentially, there are differences. These include differences in the considerations about whether professional services are capable of being distinct, and differences in how an entity should consider whether the SaaS provider's promises to the customer are separately identifiable.

Capable of being distinct

Typically, even if only as a result of customer renewals, SaaS providers sell their core SaaS offerings separately. This suggests that the core SaaS offering is capable of being distinct (i.e. in accordance with paragraph 606-10-25-20, stand-alone sales indicate the customer can benefit from the SaaS offering on its own). It also suggests that upfront professional services are capable of being distinct. Because the SaaS offering is sold separately, the professional services will provide benefit to the customer together with the readily available (by virtue of being sold separately) SaaS offering.

However, if a SaaS provider promises to significantly customize its SaaS offering for a customer (i.e. implement significant new functionalities or substantially modify existing functionalities), the upfront customization services may not be capable of being distinct unless the SaaS provider regularly sells customization services separately – e.g. if the entity sells customization services to parties that are not SaaS customers of the provider. This would indicate that the services provide benefit on their own. If those services are not sold separately, they typically would be incapable of providing benefit to the customer on their own. In addition, the customer generally could not benefit from the customization services together with any readily available resource because neither the SaaS provider, nor any other entity, sells *that* customized SaaS offering separately; it presumably does not yet exist until the customization services are complete.

Consistent with our view under legacy US GAAP, even though an entity may enter into a new contract with a customer to provide customization services that would not be combined with an original contract to provide SaaS, those subsequent customization services are not 'sold separately'. This is because with each feature added or change made, there is the implied promise to provide access to that additional or modified functionality or feature on a hosted basis. As a result, a subsequent contract to develop or modify features or functionality is a multiple-element contract, even though the hosting element is not explicitly stated. Therefore, only through sales of customization services that will not be accompanied by hosting the customized software will an entity conclude it sells those services separately.

Separately identifiable

Consistent with previous questions specific to professional services and software licensing entities (see Questions C240 – C270), professional services that do not customize the customer's instance of a SaaS offering will typically be separately identifiable (i.e. distinct within the context of the contract).

However, in some, more limited, circumstances, an entity's promise to provide professional services other than those that customize the SaaS offering may *not* be separately identifiable from the entity's promise to provide the SaaS. Consistent with the guidance for complex implementation services and configuration services provided in a software licensing arrangement (see Questions C260 and C270, respectively), this may be the case if the SaaS-related services:

— are *integral* (i.e. fundamental) to the customer's ability to derive its intended benefit from the SaaS offering – see discussion of 'integral' in Question C260; and [ASU 2016-10.BC33(b)]

— *cannot be performed by another entity* – if other entities are presently capable and available to the customer to provide the services (e.g. there is a readily available 'ecosystem' for the services), the *entity's* services are not integral to the customer's ability to derive its intended benefit from the SaaS offering. Contractual restrictions requiring the customer to obtain the services from the SaaS provider are not considered in making this assessment.

This means that other than for customization services, which will typically not be distinct from the SaaS in a SaaS arrangement, as long as another entity is capable of providing the professional services agreed to in the contract, the entity's promise to provide professional services and its promise to provide the SaaS will be separately identifiable.

Comparison to legacy US GAAP

Legacy SEC guidance in SAB Topic 13.A.3(f), 'Nonrefundable upfront fees' provided guidance about determining whether the upfront professional services in an arrangement represented a separate deliverable that should be accounted for as a separate element.

Under legacy US GAAP, the upfront services in a hosting arrangement did not represent a separate deliverable if:

1. the upfront services were essential and inseparable from the hosting services;
2. the upfront services had little or no value to the customer on a stand-alone basis; or
3. the vendor did not separately sell the upfront services or hosting services without causing a significant reduction in the value of the other element.

In those situations, the entire arrangement was accounted for as a single unit of accounting. Upfront fees were deferred and recognized systematically over the periods in which the hosting services were performed.

In general, under Topic 606, we believe upfront services that meet the second criterion above would likely be considered set-up activities, rather than promised services and, therefore, would be inseparable from the SaaS offering itself (see Question C220).

The other two criteria applied under legacy US GAAP seem mostly consistent with the conditions identified in this question for when SaaS-related services would not be distinct from the related SaaS offering under Topic 606. That is, it seems that for professional services to be 'essential' (first criterion) or for their absence from the arrangement to result in a significant reduction in value of the SaaS offering (third criterion), they would also have to be 'integral' and unavailable from an alternative provider.

Example C280.1
Upfront professional services and SaaS

ABC Corp. provides a hosted software solution to customers for which customers generally pay a fixed monthly or quarterly fee. Customers are not permitted to take possession of ABC's software. ABC and Customer enter into a contract for Customer to use ABC's SaaS for three years.

Scenario 1: Distinct services

As part of the contract, ABC agrees to perform a variety of services before Customer going live with ABC's SaaS. These services include training

Customer's personnel, converting and migrating Customer's data from its current on-premise solution to ABC's hosted environment, and building an interface to permit the hosted application to supply data to Customer's on-premise general ledger system.

The following additional facts are relevant:

— ABC's SaaS is regularly sold separately, principally through renewals with existing customers, but some new customers also choose not to obtain any professional services from ABC.
— The interface needed to permit Customer to interface the SaaS with its general ledger system is not complex, such that another entity could build that interface.
— There are third-party consultants that provide each of the services requested by Customer.

ABC first concludes that each of the promised services provide incremental benefit to Customer beyond merely permitting Customer to access ABC's hosted application (see also Question C220). Therefore, they are promised services in the contract (rather than set-up activities).

ABC next concludes that the SaaS and each of the promised services are capable of being distinct:

— ABC regularly sells the SaaS separately (principally through renewals), indicating that customers can benefit from the SaaS on its own; and
— Customer can benefit from each of the promised services – i.e. the training, data conversion/migration and non-complex interfacing – together with the readily available SaaS (the SaaS being 'readily available' by virtue of being regularly sold separately by ABC).

Finally, ABC concludes that its promises to provide each of the services and to provide the SaaS are separately identifiable. This conclusion is based on the fact that Customer could obtain each of the services from other providers or could perform the services itself. As a result, ABC's fulfillment of its promise to provide the requested services is not integral to Customer's ability to derive its intended benefit from the contract. As a result, ABC concludes that the SaaS and each of the services outlined above are separate performance obligations

However, ABC may account for the services as a single performance obligation if either of the conditions outlined in Question C250 are met.

Scenario 2: Customization services not sold separately

In addition to the services described in Scenario 1, ABC agrees to develop an additional functionality for the hosted application that it will introduce into the multi-tenant environment before Customer going live. ABC does not sell customization services separately and no other entities have access to ABC's source code for the application; therefore, no entities other than ABC could develop the requested functionality.

ABC concludes that the significant customization services in the contract transfer a promised service to the customer that has incremental benefit to Customer beyond merely setting Customer up on the existing SaaS offering such that they are not solely a set-up activity.

ABC then concludes that Customer cannot benefit from the significant customization services on their own and ABC does not sell the customized SaaS offering separately (nor does any other SaaS provider). This means that there are no readily available resources with which ABC could benefit from the customization services such that those customization services are not capable of being distinct. Because the customization services are not distinct, the SaaS and the customization services are a single performance obligation in this contract. Question F240 addresses the accounting for a combined SaaS and professional services performance obligation.

However, the combined customized SaaS performance obligation is distinct from the other professional services (i.e. those described in Scenario 1) for the same reasons that the non-customized SaaS offering and the services are distinct from each other in Scenario 1.

Scenario 3: Customization services sold separately

Assume the same facts as in Scenario 2, except that ABC regularly provides customization services separately. For example, ABC provides customization services for other entities.

ABC concludes that the customization services are capable of providing benefit to Customer on their own (evidenced by stand-alone sales thereof). The SaaS offering would also be capable of providing benefit together with the customization services provided first in the contract.

However, ABC concludes its promises to provide the SaaS and to provide the customization services are not separately identifiable because:

— the customization services are significantly customizing the core SaaS offering; and
— the customization services and ABC's core SaaS offering are inputs to the customized SaaS offering that is the desired output of this contract, indicating that ABC is providing a significant integration service in the contract.

Therefore, even in this variation of Scenario 2, the SaaS and the customization services are a single performance obligation. Question F240 addresses the accounting for a combined SaaS and professional services performance obligation.

Example C280.2
SaaS and complex implementation services

ABC Corp. provides access to its proprietary investment portfolio management software (Product C). Typically, a customer can use the Product C software-as-a-service (SaaS) with little or no customization once the basic user interface is established. ABC entered into a contract with Customer, a large international bank. Customer has numerous branches and subsidiaries around the world that operate using highly customized on-premise software.

As part of the arrangement with Customer, ABC agrees to provide Customer access to Product C on a SaaS basis, and to provide services to configure the Product C software for Customer so that it operates effectively with

Customer's branch/subsidiary software and its ERP system. In addition, ABC agrees to provide training and data migration services (migrating Customer data from multiple existing systems to ABC's hosted environment).

In evaluating its performance obligations in the contract with Customer, ABC considers first that the Product C SaaS, the configuration services, the training and the data migration services are each capable of being distinct. The Product C SaaS is capable of being distinct on the basis that it is sold separately (i.e. to customers that do not purchase professional services, and to customers that purchase the SaaS in renewal periods). Each of the services (configuration, data migration and training) is capable of being distinct because customers can benefit from each service together with the readily available Product C SaaS resource.

ABC next concludes that its promises to provide the SaaS and to provide the configuration services are not separately identifiable. ABC determines that the specialized configuration it will implement for Customer is integral to Customer's intended use of the Product C SaaS across all of its branches and subsidiaries. Stated another way, without the specialized configuration work, Customer would not be able to effectively use Product C with its different, specialized on-premise systems. Further, no resources other than ABC (i.e. no other service providers or Customer's personnel) are presently capable of providing the integral configuration services. Consistent with the discussion in paragraph BC33(b) of ASU 2016-10, Customer's ability to derive its intended benefit from this contract depends on *ABC* providing *both* the SaaS *and* the configuration services.

Finally, ABC concludes that the training and data migration services are distinct from the combined SaaS/configuration services performance obligation. The training and data migration services do not customize the hosted software and are not integral to Customer's intended use of the SaaS. The training services, while useful and valuable, are not essential to Customer's ability to use the software in view of the end-user documentation and available technical support provided as part of the SaaS. Meanwhile, the data migration services can be provided by many service providers other than ABC and do not affect the functionality of the SaaS in Customer's IT environment (in contrast to the configuration services, which do affect the functionality of the SaaS in Customer's IT environment).

Therefore, ABC concludes there are three performance obligations in the contract with Customer:

- the combined SaaS/configuration services;
- the training services; and
- the data migration services.

Hardware

Question C290

How should an entity evaluate whether a license is a component of a tangible good that is integral to the functionality of the good?

Interpretive response: Paragraph 606-10-55-56(a) states that "a license that forms a component of a tangible good and that is integral to the functionality of the good" is not distinct.

Topic 606 does not explain whether this statement is based on a conclusion that the license is, under the circumstances described, not capable of being distinct (paragraph 606-10-25-19(a)) or whether it is based on a conclusion that the entity's promises to transfer the license and the hardware are not separately identifiable (paragraph 606-10-25-19(b)). Consequently, paragraph 606-10-55-56(a) could be viewed as establishing a distinct test specifically for licenses and hardware.

However, we do not believe that was the Boards' intent. Based on discussion in the basis for conclusions to ASU 2014-09, we believe the Boards view the guidance in paragraph 606-10-55-56(a) as merely an *application* of the core distinct guidance in paragraphs 606-10-25-19 through 25-22. The basis for conclusions states that, fundamentally, the guidance in paragraph 606-10-55-56(a) refers to a situation in which the Boards believe the licensed IP and the hardware components are inputs to a combined output in accordance with paragraph 606-10-25-21(a). [ASU 2014-09.BC406]

Therefore, consistent with other Questions that consider whether two items are inputs to a combined output (e.g. C120 and C310), we believe the key question in determining whether a software license is a component of a tangible good that is integral to the functionality of the good is whether the software and the hardware components only *together* produce the essential functionality of the tangible good. Each element (software and hardware) contributes substantively to the essential functionality of the tangible good.

The hardware element(s) cannot simply be a delivery mechanism for the software. For example, a smartphone's operating system software and its hardware components work together to produce the smartphone's essential functionality (e.g. make calls, connect to the network and internet, take pictures and video); a customer would not purchase an operating system software license without a device for the software to operate, and would not purchase a smartphone without operating system software to perform the key functions that a smartphone is expected to perform.

In contrast, if the software or the hardware merely provides or contributes *additive* functionality rather than *essential* functionality, the software license is not an integral component of the tangible good. Continuing the prior example, many smartphone software applications, even if the applications come installed on the smartphone at the time of customer purchase, do not contribute to the smartphone's essential, combined functionality; they merely provide *added* functionality. In that case, the application is not an input to the smartphone – it is an additive feature.

It may require significant judgment to determine what is essential versus additive functionality. In making this determination, it may be relevant to consider whether the tangible good is ever sold without the functionality in question and whether the functionality in question is optional to the customer. This might include not only the option to include that functionality in the tangible good but also the ability to remove that functionality – e.g. uninstall the related software.

The fact that a software element included in the tangible good is also sold separately from the tangible good does not affect the assessment of whether the software and hardware elements function together to deliver that tangible good's essential functionality. Nor does the fact that the hardware elements are sold as a tangible good either without the software element or with a different software element affect this determination – e.g. a different model of the tangible good may have different essential functionality.

Comparison to legacy US GAAP

Under legacy US GAAP, the question about whether the sale of a tangible good included a software license element that functioned together with the hardware element(s) to deliver the tangible good's essential functionality was important to the accounting. This was because of the substantially different accounting models for software (and software-related services) and other goods and services.

However, under Topic 606, if the software license is transferred to the customer at the same time as the tangible good as a whole, the question about whether the software license is or is not distinct from the tangible good, as well as any related question as to whether any services in the contract are or are not software-related, may not matter.

An entity's evaluation of whether licensed software forms a component of a tangible good that is integral to its functionality will likely yield similar results as the evaluation under legacy US GAAP, but that may not always be the case. This is because the evaluation under Topic 606 is anchored to the notion that what the entity should be evaluating is whether the software and the hardware elements of the tangible good are each inputs to a combined good. This is consistent with how the factor in paragraph 606-10-25-21(a), which was not part of legacy US GAAP, is evaluated in other circumstances.

Hosting services and hybrid arrangements

Question C300

In an arrangement that includes a software license and hosting services, are the software license and the hosting services separate performance obligations?

Hosting services

In certain arrangements, rather than selling a software license and related services to the customer, the vendor will make the functionalities of the software available to the customer through a hosting arrangement. In such arrangements, the vendor will run the software application on either its own or third-party hardware. Customers can access the software through the internet or a dedicated transmission line.

Interpretive response: In contracts that include a software license (see *Chapter A – Scope*) and services to host that software, we believe the software license and those services will generally be distinct from each other (Question C310 addresses 'hybrid cloud' arrangements with cloud-based services more substantive than simply hosting the licensed software).

The software license will generally be capable of being distinct (as described in Question C110). The hosting services will also be capable of being distinct because the customer can benefit from the hosting services together with the software license that is transferred upfront. The software license in a hosted software licensing arrangement is transferred to the customer *no later than* the point in time it can first access the software through the hosted environment (see Question F110).

The entity's promises to transfer the software license and to provide the hosting services will generally be separately identifiable from each other in the contract based on the following.

— Neither the license, nor the hosting services, significantly modify or customize the other.

— The entity could fulfill those two promises independently from each other. By virtue of meeting the criteria in paragraph 985-20-15-5 to be considered a software *licensing* arrangement, it should be clear that the entity can transfer the software license independent of providing the hosting services. Further, the entity could provide the hosting services at any point during the arrangement without regard to when it transfers the software license. As a consequence of determining that the entity could fulfill the two promises independently of each other, the two promises do not each significantly affect the other.

— The customer can either host the software itself or obtain hosting services from an available third party with no significant diminution in utility of the software (a requirement for there to be a software license in the arrangement). This means that the software license and the hosting services are not inputs to a combined output for which the entity is providing a significant integration service to create.

Comparison to legacy US GAAP

The criteria for determining whether an arrangement includes a software license or, instead, is for SaaS has not changed as a result of the new revenue guidance. The existing US GAAP guidance for making this determination has merely been relocated to Subtopic 985-20 from Subtopic 985-605. *Chapter A – Scope* discusses application of this guidance in detail.

Under legacy US GAAP, when a software license was present, the software license was only separable from the hosting services if the vendor had vendor-specific objective evidence of fair value (VSOE) for the undelivered hosting services. If the arrangement included additional elements such as PCS, the software license could only be separated from the service elements if the software entity had VSOE over all of the undelivered elements (e.g. hosting and PCS services). If the entity did not have VSOE over one or both of these elements, which was often the case, the combined arrangement fee was recognized over the longer of the hosting or PCS term, provided that term was deemed to be substantive.

Having VSOE is no longer required in order to separate goods and services in software contracts, and therefore hosting services will generally be a separate performance obligation from the software licenses and other services (e.g. PCS or implementation) in the contract. Therefore, entities that enter into software licensing arrangements with hosting services will generally separate the license and the hosting services more frequently than they do under legacy US GAAP.

Example C300.1

Software license, customization services and hosting services

ABC Corp. enters into an arrangement with Customer to license software Product A, provide significant customization services and provide hosting services. The hosting services commence upon completion of the customization, which is expected to take approximately six months.

The hosting services may be renewed in subsequent years for an amount to be negotiated between ABC and Customer. Customer has a contractual right to take possession of Product A at any time without significant penalty, and it is feasible for Customer to run the software on its own hardware.

Because Customer has a contractual right to take possession of Product A at any time without significant penalty and it is feasible for Customer to run the software on its hardware, ABC concludes that there is a software license and associated hosting services in this contract. The significant customization services transfer a promised service in this contract – i.e. they provide incremental benefit to the customer; therefore, they constitute a third promised good or service in the contract.

ABC concludes that the software license and each of the services is capable of being distinct because the:

- Customer can benefit from the software on its own. Customer can run the software on its own hardware, and it is capable of providing economic benefit to the customer without significant customization;
- Customer can benefit from the customization services together with the software license that is granted at the outset of the contract; and
- Customer can benefit from the hosting services together with the software that is transferred to the customer when the hosting services commence (i.e. when Customer is able to begin to access the software).

ABC next determines that its promises to transfer the software license and to provide the customization services are not separately identifiable. This is because the services are significantly customizing ABC's software such that the licensed software and the customization services are inputs to the combined, customized software offering for which the customer has contracted (see Example C230.1).

Finally, ABC determines that its single promise to provide the customized software license (comprised of the license to the software and the customization services) is separately identifiable from the hosting services. The hosting services are not changing (i.e. customizing or modifying), or being changed by, the customized software license such that each is an input to a combined output. Further, because Customer can host the customized software on its own, ABC could fulfill its promise to transfer the customized software license independent of its promise to host the customized software. And because ABC could provide equivalent hosting services to Customer for another application, it could also fulfill its promise to provide hosting services independent of its promise to transfer the customized software license. Therefore, the customized software license and the hosting services are not highly interrelated or interdependent.

As a result of the preceding analysis, ABC concludes that there are two performance obligations in this contract – i.e. the customized software license and hosting services.

Question C310

What should an entity consider when evaluating whether a software license and a SaaS element in a 'hybrid SaaS' (or 'hybrid cloud') arrangement are distinct from each other?

Interpretive response: It is increasingly common for arrangements to include on-premise or on-device software and SaaS features and functionality (a SaaS element), e.g. an on-premise software application and file storage (including sharing and collaboration through a web host), or a SaaS application with an offline mode. These arrangements are often referred to as hybrid SaaS or hybrid cloud arrangements.

Paragraph 606-10-55-56(b) states explicitly that a license that the customer can benefit from only in conjunction with a related service (e.g. as an online service provided by the entity that enables, by granting a license, the customer to access content) is not distinct.

If the customer cannot derive benefit from its right to use licensed software without a contracted SaaS element, that license is not distinct from the SaaS element. This is the case even if that license is subject to an end-user license agreement or the license is explicitly stated to be an element of the contract. We believe this conclusion would extend, not only to a situation in which the customer receives no independent benefit from the on-premise software license, but to any situation in which the benefit (or utility) that the customer can derive from the on-premise software independently is insignificant.

When the on-premise software and the SaaS element each have substantive functionality on their own, we believe that the evaluation an entity should undertake in determining whether the on-premise license and the SaaS element are distinct is broadly consistent with the approach outlined in Question C120 (contract with multiple software licenses).

That is, we believe the underlying principle for the separation model in Topic 606 (as outlined in paragraphs BC29, BC32 and BC33(b) in ASU 2016-10) provides that a software license and a SaaS element will typically be distinct if the two elements are 'additive' to each other, but will *not* be distinct from each other when those two elements have a 'transformative' or significantly 'magnifying' effect on each other, or when the customer's ability to derive its intended benefit from the contract depends on the software entity transferring the on-premise software license *and* providing the SaaS features (see paragraph BC33(b) in ASU 2016-10).

Excerpt from ASU 2016-10

BC29. The Board intends to convey that an entity should evaluate whether the contract is to deliver (a) multiple goods or services or (b) a combined item or items that is comprised of the individual goods or services promised in the contract. That is, entities should evaluate whether the multiple promised goods or services in the contract are outputs or, instead, are inputs to a combined item (or items). The inputs to a combined item (or items) concept might be further explained, in many cases, as those in which an entity's promise to transfer the promised goods or services results in a combined item (or items) that is greater than (or substantively different from) the sum of those promised (component) goods and services.

BC32. The separately identifiable principle is intended to consider the level of integration, interrelation, or interdependence among promises to transfer goods or services. That is, the separately identifiable principle is intended to evaluate when an entity's performance in transferring a bundle of goods or services in a contract is, in substance, fulfilling a single promise to a customer.

Therefore, the entity should evaluate whether two or more promised goods or services (for example, a delivered item and an undelivered item) each significantly affect the other (and, therefore, are highly interdependent or highly interrelated) in the contract. The entity should not merely evaluate whether one item, by its nature, depends on the other (for example, an undelivered item that would never be obtained by a customer absent the presence of the delivered item in the contract or the customer having obtained that item in a different contract)…

BC33. In addition to reframing the factors in the context of a bundle of goods or services, the Board also:

b. Observed that the evaluation of whether two or more promises in a contract are separately identifiable also considers the utility of the promised goods or services (that is, the ability of each good or service to provide benefit or value). This is because an entity may be able to fulfill its promise to transfer each good or service in a contract independently of the other, but each good or service may significantly affect the other's utility to the customer. For example, in Example 10, Case C, or in Example 55, the entity's ability to transfer the initial license is not affected by its promise to transfer the updates or vice versa, but the provision (or not) of the updates will significantly affect the utility of the licensed intellectual property to the customer such that the license and the updates are not separately identifiable. They are, in effect, inputs to the combined solution for which the customer contracted. The "capable of being distinct" criterion also considers the utility of the promised good or service, but merely establishes the baseline level of economic substance a good or service must have to be "capable of being distinct." Therefore, utility also is relevant in evaluating whether two or more promises in a contract are separately identifiable because even if two or more goods or services are capable of being distinct because the customer can derive some economic benefit from each one, the customer's ability to derive its intended benefit from the contract may depend on the entity transferring each of those goods or services.

Stated another way, if the customer obtains a license to Software Product A and access to SaaS element B, the distinct analysis would frequently hinge on whether:

— the combination of A + B equals AB (i.e. the combined functionality is the sum of the two elements' individual functionalities), in which case the two elements would generally be distinct from each other; or *instead*

— the combination of A + B equals X (where X is greater than AB). That is, the combination of the two elements results in incremental or changed functionalities that don't exist in either element separately or the combination of the elements (e.g. ongoing interactions between the licensed software and the SaaS) produces an enhanced level of functionality that is greater than the aggregate of the individual functionalities of the two elements, which would generally suggest the two elements are not distinct from each other.

Additionally, the distinct analysis may hinge on whether *both* elements (i.e. the on-premise/on-device software *and* the SaaS element) are essential to fulfilling the promise to the customer. That is, the nature of the promise to the customer in a hybrid SaaS arrangement may include the promise of access to important features or functionalities that depend on *both* elements. A situation in which the entity must provide both elements (i.e. there are not substantially equivalent alternatives for either the licensed software or the SaaS features/functionality available from other providers), might suggest that the software license and SaaS elements are not distinct from each other.

Example C310.1
On-premise software part of a combined solution

ABC Corp. contracts with customers to provide access to its proprietary solution that permits entities to obtain specific data and manipulate it in numerous ways. ABC's solution includes hosted software and an on-premise application.

The hosted application is proprietary, and ABC never permits customers to take possession of the hosted application or have another entity host the application. The on-premise application is licensed to and used by ABC's customers to view search results and data presentations processed by the hosted application, but the on-premise application is unable to produce search results or work with searched data when not connected to the hosted application.

A customer uses the on-premise application to convert the results into other, more usable formats (e.g. Word, Excel and PDF) and can send the results to others using the application. Customers enter into end-user licensing agreements for the on-premise application as part of the contracting process that are co-terminus with their access to the hosted application.

The on-premise application has some inherent functionality, i.e. as a stand-alone application, it permits a user to convert results into other formats and to share results with others. Notwithstanding that fact, ABC concludes that neither the on-premise application nor the hosted application provides independent functionality to customers. Without the hosted application, the on-premise application would not be able to obtain search results or data reports to convert or send to others, while a customer cannot obtain the results produced by the hosted application without the on-premise (user interface) application.

Consequently, ABC concludes that the on-premise application license is not capable of being distinct. Customers cannot benefit from the on-premise application on its own (i.e. without the hosted application) or together with other readily available resources. No other hosted applications exist that a customer can use with ABC's on-premise application, and ABC does not sell access to its hosted application separately. It sells that access only with co-terminus licenses to the on-premise application.

Because the on-premise application is not capable of being distinct, it is combined with the hosted application into a single performance obligation. The substance of that combined performance obligation is the service of providing access to ABC's solution for the defined contract period.

Example C310.2

SaaS with an 'offline mode'

ABC Corp.'s core solution to customers is marketed as a Cloud Service; however, the solution includes on-premise software subject to an end-user license agreement. Customers can perform many of the solution's functionalities when they are not connected to ABC's cloud (i.e. they are offline, using the on-premise software only), but other functionalities are accessible only if connected to ABC's cloud.

ABC does not sell the on-premise software or functionalities separate from its cloud service. Consistent with Example C310.1, customers cannot access the cloud functionalities without the on-premise software; that software is what permits the customer to access the cloud features.

While there are substantive capabilities available to the customer in offline mode, without the cloud features, customers would not be able to complete projects using the software. This is because the offline mode permits the customer to perform only some tasks toward completing projects using the software while other significant features and functionalities integral to completing projects are available only when using the software while connected to the cloud. The ability to create and complete entire projects is the reason customers acquire ABC's solution.

There are (1) no other on-premise applications that work together with the cloud component of the solution and (2) no other on-premise or cloud solutions available that customers could combine with ABC's on-premise software and achieve the functionality provided by ABC's overall solution. Customers would have to backtrack substantially or do a significant amount of re-work to achieve the same results outside of ABC's application.

Despite the characterization of the solution as a single Cloud Service, the solution includes a license to the on-premise software and access to ABC's hosted application in the cloud. Therefore, ABC determines that it must evaluate whether the license and the cloud-based SaaS are distinct from each other.

ABC concludes that the license and the cloud-based SaaS are capable of being distinct. This is because customers (1) can benefit from the on-premise software on its own and (2) can benefit from the SaaS together with the on-premise software license transferred to the customer upfront.

Customers can benefit from the on-premise software on its own despite the fact that they would generally have to backtrack or undertake re-work to complete projects started with the on-premise software on its own. Customers are able to derive economic benefits from use of the on-premise software because they would not have to re-perform all of the work they had completed using the offline mode only. For example, even if the customer would have to re-input and modify data or configurations developed using ABC's on-premise software into another application to complete the project, ABC's software would have provided the customer with a platform to try out various models, processes and/or configurations that would generally provide benefit when moving forward using another solution.

Despite concluding that the license and the SaaS are capable of being distinct, ABC concludes that its promise to grant the on-premise software license and to provide the cloud-based SaaS are not separately identifiable. ABC concludes that its solution, the combination of the license and the SaaS, provides combined functionality that is essential to the customer deriving its intended benefit from the arrangement. That intended benefit cannot be provided by either the license and other cloud-based services or software, or other software and ABC's cloud-based services.

In substance, the on-premise software license and the cloud-based SaaS are inputs to the combined output (i.e. the solution) that the customer entered into the contract to obtain, and each element significantly affects the utility of the other to the customer such that the nature of ABC's overall promise to its customers is to provide the solution as a whole, not to transfer a license and provide access to additional cloud-based services.

Example C310.3

On-premise software with 'additive' SaaS functionality

ABC Corp. markets its core software development solution to customers as a Cloud Service; however, the solution includes both on-premise software subject to an end-user license agreement and cloud-based services. Neither the license, nor the cloud-based services, are optional in ABC's contracts and ABC does not sell the on-premise software separate from the cloud services. The on-premise software license and the cloud services are co-terminus in all of ABC's contracts.

The essential functionalities of the solution are in the on-premise software and are accessible offline or connected to ABC's cloud. The cloud services offer customers protected data storage and can be accessed by multiple users, in-app information sharing and real-time collaborative abilities, e.g. the ability for two users in separate locations to work in the same template simultaneously. However, they do not change or significantly enhance what a single user can develop using the software – i.e. a customer working offline would be able to undertake the entire software development project permitted by ABC's solution – or significantly affect the workflows to accomplish the customer's development tasks.

Consistent with Example C310.2, ABC concludes that there are two promised goods and services in the contract: a license to the on-premise software, and access to the cloud-based features.

Next, ABC concludes that the license and the cloud-based features are capable of being distinct. This is because customers can benefit from the on-premise software on its own and can benefit from the cloud features together with the on-premise software license transferred to the customer upfront. Customers can benefit from the on-premise software on its own because they can take a software development project through the entire project lifecycle using the software in an offline mode – i.e. without accessing the cloud-based features.

ABC next concludes that its promises to transfer the on-premise software license and provide access to its cloud-based features are separately identifiable. ABC decides that the cloud-based features, while valuable and likely influential to a customer's decision to purchase ABC's solution, are additive to the on-premise software, rather than transformative. The cloud-based features provide a collaborative and secure environment for sharing and storing files and other data and, while those features (and others), may enhance the productivity of a team working together to complete a project, they do not change (i.e. modify or customize) the functionality of the on-premise software or significantly enhance the on-premise software's capabilities, nor do those features significantly optimize the workflows to complete those projects.

A customer can complete the same software development projects in offline mode as it could using the software together with the cloud-based features and in a similar manner (i.e. the customer does not have to undertake significant, incremental efforts when in offline mode compared with cloud-enabled mode to complete a development project). Consequently, the software license and the cloud-based features are not inputs to one overall solution.

Example C310.4
Flexible hybrid arrangement

ABC Corp. licenses its software (Product Q) on an on-premise (term license) basis and on a software-as-a-service (SaaS) basis. Some of ABC's customers enter into 'Flex' arrangements whereby they are permitted a designated number of concurrent users (e.g. 100 concurrent users), but the mix between on-premise and SaaS users can vary over time. For example, the customer would be permitted to have all 100 concurrent users accessing the on-premise software, all 100 concurrent users accessing the software via the cloud, or any mix in between. There is also no requirement for a specific employee of one of these customers to always access the software via the on-premise software or via the cloud. The Flex arrangements include technical support and the right to unspecified updates, upgrades and enhancements (collectively, PCS). Updates, upgrades and enhancements are implemented by ABC to the hosted instance of Product Q immediately on release.

In evaluating the number of performance obligations in its Flex contracts, ABC considers that:

- the Product Q software is the same software, whether accessed on-premise or via the cloud (note: the possible exception would be the period of time between when the customer is provided an update or upgrade and when they implement that update or upgrade to their on-premise software);
- a customer user is not accessing the on-premise software *and* cloud-based software concurrently; the user is using the on-premise instance of the Product Q software *or* is accessing the hosted instance of the software; and
- a user is not accessing the on-premise software and cloud-based software concurrently, therefore, there are not ongoing interactions between the two or any 'integrated (or combined)' features or functionalities.

ABC concludes that its Flex contracts include a term license to the Product Q software that is distinct from a Product Q SaaS element (i.e. the right to access Product Q via ABC's cloud).

ABC next considers whether the PCS related to the term license, consistent with Questions C150 – C170, is a single performance obligation, separate from the performance obligation to transfer the Product Q license. If ABC concludes PCS is a single, distinct performance obligation, it would have three performance obligations in the arrangement – i.e. the term license, SaaS, and PCS.

Unspecified additional software product rights

Question C320

Are rights to use unspecified (when-and-if available) additional software products and an initial software license(s) distinct from each other in a software licensing arrangement?

Rights to use unspecified additional software products

As part of a multiple-element arrangement with a user, an entity may agree to transfer software licenses currently and to transfer unspecified additional software licenses in the future. For example, the entity may agree to transfer licenses to all new software products to be introduced in a family of products over the next two years.

A right to receive unspecified additional software licenses is typically evidenced by the entity's agreement to grant the customer rights to use new products introduced by the entity within a specified time period without regard to the specific features and functionality of the new products.

These arrangements are similar to arrangements that include rights to unspecified upgrades. Nevertheless, they are distinguished from arrangements that include unspecified update/upgrade rights because the future deliverables are rights to use additional software products, not unspecified updates, upgrades or enhancements to existing software products to which the customer has rights to use.

Interpretive response: Question C110 discusses when a software license is considered capable of being distinct. In addition, we expect that, by nature, the right to unspecified future software licenses would have benefit to the customer either:

- on its own – e.g. those licensed products may be off-the-shelf applications the customer can benefit from immediately upon download; or
- together with readily available resources – e.g. implementation services it could obtain relative to those additional products or the initial software license(s) provided initially under the contract.

We believe the analysis of whether promises to transfer a software license and to provide unspecified future software licenses when-and-if additional software products are developed are separately identifiable will be similar to that for a software license and unspecified update/upgrade/enhancement rights (see Question C170). Similarly, we believe that in most contracts, the promise to transfer the software license and the promise to provide unspecified future software licenses will be separately identifiable from each other. This is because:

— The promise to *later* (i.e. *subsequent* to transfer of the initial software license) transfer a license to any future software products produced means that the entity is not providing a significant integration service to transfer a single, combined output that uses the initial license and subsequently developed software products as inputs. These arrangements are not analogous to the multiple license scenario described in Question C120.

— The initial license and additional, unspecified licenses that may be transferred in the future are not inputs to a combined output – i.e. inputs to a combined software system or solution. This means that generally the entity can fulfill its promise to transfer the initial software license separately from fulfilling its promise to transfer future unspecified licenses. Typically, the entity will fulfill its promise to transfer any initially promised software licenses before any future additional software products are even developed and will likely sell licenses to the future software products to new or existing customers that have not licensed the software promised initially in the contract; this evidences that the entity can transfer the promised and the future licenses independently. Consequently, the license and the unspecified future software product rights are not highly interrelated or interdependent.

— By definition, an additional software *product* does not modify or customize the initially licensed software because it is a new product; a release that modifies or customizes existing software would be characterized as an upgrade or an enhancement.

However, in more limited circumstances, the promise to transfer a software license may not be separately identifiable from the promise to provide unspecified future software licenses when-and-if additional software products are developed. We believe that the fundamental question to be asked in determining whether those two promises are separately identifiable is whether:

— the future software licenses will be 'additive' to the initial software license – i.e. those future software licenses will provide additional functionality/utility to the customer; or instead
— will effectively 'replace' the software license(s) initially provided – i.e. the customer will stop using the initially licensed software (e.g. because it is made obsolete by the new software products) in favor of the new software.

In the former, 'additive' case, we believe the two promises are separately identifiable; the unspecified future software licenses right does not *significantly* affect the utility of the initial software license(s) to the customer.

In contrast, a customer may enter into a license, for which it is expected that the initially licensed software will need to be, in effect, replaced by one or more new software products in order to continue to provide the customer with substantive utility; this would suggest that the nature of the entity's overall promise to the customer is, fundamentally, to provide ongoing access to the entity's software developments throughout the license period. The initial software license(s) and the unspecified future software license right are inputs to that overall, combined promise.

In these cases:

— the utility of the initially licensed software degrades *significantly* during the license period (and not predominantly at or near the end of that period only);

— customers' use of the initially licensed software ceases or substantially changes in character – e.g. from use in commercial production to use solely in supporting prior production – within a reasonably short period of time from the release of new software products; and

— updates, upgrades and new software products to which customers obtain rights are downloaded and used by the customers. For example, customers timely downloading and/or installing the software or, if the contracts include remix rights into future software products, demonstrating that customers regularly remix their existing licenses into newly-released software products.

Comparison to legacy US GAAP

If an arrangement included unspecified additional software products, legacy US GAAP specified that the entire arrangement be accounted for as a subscription even if the vendor did not intend to develop any new products during the term of the arrangement. Under subscription accounting, no allocation of revenue was made among any of the software products, and all software-related revenue (including PCS) from the arrangement was recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement was not stated, revenue was recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product.

In subscription arrangements that included professional services, entities separated the subscription element (i.e. the combined element of the upfront software product and the rights to unspecified future additional software products) from the services element based on vendor-specific evidence of fair value (VSOE). Revenue allocable to the subscription element was recognized ratably over the subscription period (or the economic life of the software if no term was specified), and revenue allocable to the services was recognized as they were performed. If the vendor did not have VSOE over the subscription element, which was typically the case, the entire arrangement fee was required to be recognized ratably over the longer of the term of the subscription (or the economic life of the software if no term was specified) or the period over which the services were to be provided, beginning with delivery of the first software product.

If a subscription element existed in an arrangement that would have been accounted for under contract accounting, it was not considered separable from the contract accounting element. Therefore, vendors recognized revenue equal to the lesser of (1) the amount resulting from the application of contract accounting or (2) the amount resulting from the application of subscription accounting (ratable). Due to the nature of unspecified additional software products, vendors generally could not reasonably estimate progress toward completion and the range of costs under the arrangement. Therefore, vendors measured the amount of revenue resulting from the application of contract accounting either under the completed contract method or, if some level of profitability was reasonably assured, a zero gross margin percentage-of-completion approach.

In most cases, rights to unspecified additional software products will be distinct from a software license or from a combined software license and professional services performance obligation – e.g. software license and customization services. Therefore, under Topic 606, there will likely be a significant change in accounting for many entities that include unspecified additional software product rights in their contracts.

Entities will, in those cases, recognize revenue for the:

— software license at the point in time that it is transferred to the customer; or for a combined software license/services performance obligation, over the period that the services are performed; and

— unspecified additional software product rights, in most cases ratably over the period that those rights exist. The same considerations as outlined in Question C130 for unspecified update/upgrade/enhancement rights will generally apply to unspecified additional software product rights when determining whether those rights are a stand-ready obligation, and in determining the appropriate measure of progress to apply when recognizing revenue.

Questions F230 and F270 address accounting for combined performance obligations that include a right to unspecified updates, upgrades and enhancements or unspecified additional software product rights.

Example C320.1
Contract with rights to unspecified additional software products

ABC Corp. is a vendor of financial accounting software. ABC enters into a contract with Customer to license its revenue accounting software, which is currently available. In addition, ABC agrees to grant Customer a license to any related software introduced over the next three years that is designed to work specifically with the revenue accounting software (e.g. customer relationship management or billing software). ABC considers any new software developed that would be subject to this provision to be additional software products, rather than upgrades or enhancements, because such software would be marketed and licensed as stand-alone products that do not need to be used with the revenue accounting software.

The revenue accounting software is, and any future software products ABC develops will be, off-the-shelf software that is fully functional upon basic installation. Customer can do the installation itself or engage any number of alternative providers.

ABC first determines that there are two promised goods or services in the contract:

- the software license for the revenue accounting software; and
- the right to use unspecified additional software products (when-and-if developed).

ABC next concludes that the revenue accounting software license and the right to use unspecified future software products are each capable of being distinct. Customer can benefit from the initial revenue accounting software license and any future licenses to additional software products on their own (or together with basic installation services that are readily available). This is because the revenue accounting software is, and any future software products are expected to be, fully functional after only basic installation.

Lastly, ABC concludes that its promises to transfer the revenue accounting software license and to transfer a license to any future software products are separately identifiable. This is because, even if *complementary*, the new software products will not change the functionality of the revenue accounting software. Similarly, the revenue accounting software will not change the functionality of the additional software, which will be marketed (and is expected to be licensed) separately from the revenue accounting software.

Consequently:

- neither the initial software license, nor the right to use future software products, is significantly modifying or customizing the other;
- the initial software license and the right to use future software products are not inputs to a combined software system or solution; and
- because the revenue accounting software is licensed on its own and the future software products are similarly expected to be licensed on their own, they are not highly interrelated or interdependent.

Based on the above, the revenue accounting software license and the right to use unspecified future software products are distinct from each other, and therefore separate performance obligations.

Example C320.2
Non-distinct unspecified update/upgrade and additional software product rights

ABC Corp. enters into a contract with Customer to license its current commercial software applications for three years. ABC also promises to provide Customer with all updates, upgrades and enhancements it develops for that software, as well as to provide Customer with a license to any new software it develops during the license period within the same family of software products.

ABC develops software used by customers in a rapidly changing field – the parameters of the field itself have been changing for some time and are expected to continue to change for the foreseeable future. Therefore, ABC's software must also change rapidly in order for ABC's customers to use ABC's software within this field of development. ABC's customers expect regular and timely updates, upgrades and new products that keep pace with the changes in their field because such updates are necessary for them to continue to derive benefit from the software. ABC's software would not be expected to remain useful, in any substantive respect, to its customers throughout its typical three-year (and sometimes five-year) license periods. Consequently, ABC's customers never purchase ABC's software licenses without unspecified update/upgrade/enhancement and unspecified future software product rights, while ABC invests heavily in R&D and regularly releases either updates (or upgrades) to its existing software products or new software products (that, in effect, take the place of older software products) to address new areas of research within the field of its customers.

The necessity of ABC's updates and new software products to its customers, as well as the pending obsolescence of older versions and software products at the time new versions and products are released, is evidenced by the fact that those customers:

- almost universally download nearly all (1) updates and upgrades to existing software products and (2) new software products within a short period of time; and
- remix all or a substantial portion of their licenses from older products to new software products immediately or shortly after ABC releases them.

ABC determines that there are three promised goods and services in this contract: the licenses to ABC's existing software products (which are transferred to the customer at contract inception) for three years, rights to any updates/upgrades of the existing software developed during the three-year contract term and rights to use additional software products developed by ABC during the three-year contract term.

ABC concludes that all three promised items are capable of being distinct. Each provides benefit to ABC either:

- on its own – e.g. customers can derive economic benefits from the initial software licenses and software licenses granted during the contract term on a when-and-if available basis; or
- together with other readily available resources – e.g. the right to when-and-if available updates/upgrades of the existing software provide benefit to Customer together with the initial software licenses transferred at contract inception.

However, ABC concludes that its promises to transfer the initial software licenses, provide unspecified updates/upgrades/enhancements and provide unspecified additional software product rights are not separately identifiable. The three individual promises are inputs to a combined overall promise to Customer in the contract.

In reaching this conclusion, ABC considers that its initial software licenses, without substantive updates/upgrades, would not provide significant benefit to Customer throughout the license period. Absent timely updates/upgrades (or new, replacement software products) Customer would likely stop using ABC's software and develop/acquire an alternative solution well before the end of the license period. Consequently, Customer would be highly unlikely to enter into a three-year license arrangement with ABC absent the promise of timely updates/upgrades and/or replacement software products to keep pace with rapid developments in its field. As outlined above, the significant decline in utility of the initially licensed software, as well as the need for the updates/upgrades and additional software products, is evidenced by the fact that ABC's customers:

— almost universally download nearly all of the updates/upgrades (or new software products) provided immediately (or shortly after they are released); and

— exercise their remix rights to remix into the new software products (or upgraded versions of existing products) to which they obtain rights immediately (or shortly after) ABC provides them and out of older versions or older products once updates/upgrades or replacement products are provided.

Therefore, ABC concludes that the initial licenses, the unspecified update/upgrade/enhancement rights and the unspecified future software product rights are a single performance obligation. This is despite the fact that (1) ABC would generally be able to fulfill each of the three promises independently and (2) ABC is not providing a significant service of integrating the initial licenses, the unspecified updates/upgrades/enhancements and the unspecified future software licenses into a single, integrated 'solution' or 'system'. The nature of ABC's combined performance obligation in this arrangement is to provide Customer with ongoing access to its evolving software in Customer's field for the three-year term of the contract.

Question C330

Are the considerations as to whether promised SaaS and a right to access unspecified additional software products as a service distinct from each other different from those in a software licensing arrangement?

Interpretive response: In general, no. We believe the considerations would be substantially the same as those outlined in Question C320.

However, the promise to provide access to future hosted software products may be co-terminus with the promised SaaS, and the two promises may have the same pattern of transfer to the customer – e.g. if the entity concludes that both promises are satisfied over time and that a time-based measure of progress toward satisfaction of each promise is appropriate. In that case, the entity is permitted to account for the SaaS and the right to access future hosted software products as a single performance obligation, regardless of whether the two items are distinct.

Question C130 provides considerations about whether a right to unspecified updates, upgrades and enhancements is a stand-ready obligation; and, if it is, determining the measure of progress toward complete satisfaction of that obligation. We believe the considerations for a right to access future hosted software products are substantially the same as those outlined in that question.

Specified upgrades and rights to use additional software products

Question C340

Are specified upgrades and rights to specified additional software products additional promised goods in a contract with a customer? If so, are they distinct from the other goods or services in the contract?

Specified upgrades

A specified upgrade right is generally an entity's explicit commitment to deliver, or agreement to deliver on a when-and-if available basis, a specific version of the software or an upgrade with specific features and functionality. Any discussion in the contract with the customer of possible features and functionality of future versions of the software would generally represent a specified upgrade right.

An entity may implicitly grant its customer a specified upgrade right, without there being explicit discussion in the contract. This is the case when the entity provides assurance to the customer that a future product release will contain specific features and/or functionality. This might occur, for example, through communication of a detailed software product roadmap (i.e. marketing materials) or in a non-contractual response to a customer's request for proposal.

As a practical matter, claims made in marketing materials available to customers and commitments by sales personnel may be considered by the customer to be part of the arrangement, and therefore represent a specified upgrade right. The specific facts and circumstances should be evaluated on a case-by-case basis, and the entity may need to consult with its financial and legal advisers to determine if a specified upgrade right has been granted implicitly to a customer.

Factors to consider when evaluating whether an implicit specified upgrade right has been granted to a customer include the following:

— ***Upgrade/enhancement detail*** – the level of detail of the features, functionality and general release timeframe of the future product that has been provided to the customer. The greater the level of detail and the closer the release date of the enhancement to the initial contract, the greater the likelihood that the entity has created an expectation by the customer of the release of the future identifiable upgrade/enhancement that may have affected the customer's purchase decision.

— ***Caveat language*** – whether the entity's use of caveat language detailing the product roadmap and future development efforts in a license arrangement gives rise to uncertainty about whether the customer will receive the product upgrades/enhancements. The greater the level of uncertainty about the future delivery of an upgrade/enhancement, the less likely that the entity has created an expectation by the customer of the release of the future identifiable upgrade/enhancement.

— ***Customer communication*** – whether the entity communicates the features, functionality and timeframe for general release of the future product, or communicates a release to only certain identifiable customers. The broader the intended distribution of the product and the more specific the communication is about functionality and features of the program, the greater the likelihood that customers would expect to receive the specified product upgrades/enhancements.

— ***Entity's history*** – an entity's history of charging a substantive amount for product upgrades/enhancements would indicate that the product may not be a specified upgrade.

— ***Customer request*** – whether the customer requests or requires a roadmap to specify specific features and/or functionality that are not available currently in the marketed product. Such a request or requirement would indicate that the product roadmap may be a specified upgrade.

Specified additional software products

As part of a multiple-element arrangement, an entity may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be included either in the terms of a PCS contract or in a separate agreement, or may be implied in much the same manner as specified upgrade rights.

In determining if a specified software deliverable is an upgrade/enhancement or a product, a vendor should consider carefully the specific facts and circumstances on a case-by-case basis. Factors to consider include the following:

— ***The significance of the differences in the features and functionality of the new deliverable from the vendor's existing products.*** If the new deliverable has significant differences in the features and functionality from the vendor's existing products, or if the new deliverable performs functions outside the domain of the vendor's existing products, it may indicate that the deliverable is a product rather than an upgrade/enhancement.

— ***Replacement of existing products.*** If the new deliverable is intended to substantially replace the vendor's existing products, it may indicate that the deliverable is an upgrade/enhancement rather than a product.

- ***The extent of development activities.*** If the new deliverable required a significant development effort, it may indicate that the deliverable is a product rather than an upgrade/enhancement.
- ***The relationship of the price of the new deliverable to the pricing for the vendor's existing products***, including price discounts to existing customers. If the new deliverable is priced (or expected to be priced) at an amount that is significantly higher than the price of the entity's existing products, or if the existing users of the vendor's products are offered no discount or only an insignificant discount for the purchase of the new deliverable, it may indicate that the deliverable is a product rather than an upgrade/enhancement.
- ***The manner in which the new deliverable is marketed.*** If the new deliverable is marketed as a different product, it may indicate that the new deliverable is a product rather than an upgrade/enhancement.
- ***Product name.*** If the new deliverable has a different name than the entity's existing products it may indicate that the deliverable is a product rather than an upgrade/enhancement.

Interpretive response: A promise to grant a customer the right to use specific IP (e.g. an upgraded version of software, a new functionality or a new software product) is a promised good under Topic 606. Both specified upgrade rights and rights to specified additional software products, whether explicit in the contract *or implicit* through another form of commitment or customary business practice, represent promises to deliver a specified good to the customer.

The considerations with respect to whether specified upgrades or enhancements or additional software products are distinct from other goods or services in a contract are not different from those that apply to other promised goods and services. However, we typically expect rights to use software that will be transferred in the future to be distinct from goods or services that are:

- transferred upfront – e.g. a software license transferred upfront; or
- begin to be provided at the beginning of the contract – e.g. PCS related to a transferred software license or professional services to implement that licensed software.

This is because something that will come only later will typically *not* be an input to a combined item together with a software license to (e.g. an earlier version or a different software product) that is transferred first or services that pertain to the software license that is transferred first.

Further, the initial license can be transferred and services related to that license provided before the specified version, enhancement or additional software product is available for release; and the specified version, enhancement or additional software product can be transferred to the customer (or new customers) independently at a later date. This indicates that those items are not highly interrelated or interdependent. However, all relevant facts and circumstances will need to be considered.

Comparison to legacy US GAAP

Under legacy US GAAP, because vendor-specific objective evidence of fair value (VSOE) rarely, if ever, existed for specified upgrades, enhancements or additional software products, the inclusion of one of those items in arrangement generally resulted in the deferral of all consideration in the arrangement until the specified item was delivered to the customer. When a specified upgrade, enhancement or additional software product was promised to the customer that was not yet developed, this meant that the software entity might recognize no revenue under the arrangement for a significant period of time. This was the case even if all of the other elements of the contract were delivered – e.g. software and professional services.

The accounting effect of promising specified upgrades, enhancements or additional software products is significantly less onerous under Topic 606 because of the elimination of the VSOE separability requirement. In most cases, because the specified item will be distinct from the other promised goods or services in the contract, the promise to transfer the specified item will not result in the deferral of *all* contract consideration. Instead, only the portion of the contract consideration allocated to that promised good or service will be deferred until the specified item is transferred to the customer.

Example C340.1
Implicit specified upgrade

ABC Corp. receives a request for proposal (RFP) from Customer that indicates that Customer desires incremental XYZ functionality in the general ledger software it plans to purchase. In a written response to Customer's RFP, ABC states that although XYZ functionality currently is not available in Version 4.0 of Product A (ABC's currently available general ledger software), ABC anticipates that XYZ functionality will be available in Version 4.1 of Product A, which is expected to be released in approximately six months.

Subsequent to the RFP process, ABC enters into a contract with Customer to transfer a license to Version 4.0 of Product A and to provide Customer with a right to any future updates, upgrades and enhancements to Product A, when-and-if available, for a period of one year. The arrangement does not explicitly discuss the XYZ functionality.

ABC determines that there are three promised goods and services in this contract: the software license for the general ledger software (Version 4.0), the right to unspecified updates/upgrades/enhancements and the specified upgrade right to XYZ functionality.

ABC has implicitly promised to provide XYZ functionality to Customer through its communication in the RFP. This created a reasonable expectation on Customer's part that ABC will deliver the functionality through a future update.

ABC concludes that the general ledger software license and the right to *unspecified* updates, upgrades and enhancements are distinct from each other (see Question C170 and Examples C170.1 and C320.1).

ABC also concludes that the specified upgrade right to XYZ functionality is distinct:

— Customer will be able to benefit from the XYZ functionality together with the Product A software specifically licensed in the contract – i.e. the XYZ specified upgrade is capable of being distinct; and

— ABC's promise to transfer the XYZ functionality is separately identifiable from the other promises in the contract (i.e. to transfer a license to Version 4.0 and future unspecified updates/upgrades/enhancements). This is because the XYZ functionality will not significantly modify or customize the Version 4.0 software; rather it will provide an incremental functionality. Consequently, the XYZ functionality is not an input, together with the Product A software or the unspecified updates/upgrades/enhancements, to a combined output in this contract. Lastly, ABC is able to transfer a license to the Version 4.0 software independently of transferring any future XYZ upgrade, and similarly would be able to transfer a license to a later version of the software independently – e.g. to a new customer that enters into a contract to license the software once XYZ functionality is part of the commercial release version of the software. Therefore, the initial Version 4.0 license and the XYZ upgrade are not highly interrelated or interdependent.

Based on the above, ABC concludes that the initial, Version 4.0 software license, the unspecified update/upgrade/enhancement rights and the XYZ specified upgrade are each distinct, and therefore each separate performance obligations.

Question C350

If a SaaS provider makes a promise to a customer to add functionalities or features to its SaaS, is that an additional promised service in the contract with the customer? If so, is that promised service distinct from the original SaaS service?

Interpretive response: SaaS providers frequently either provide customers with an explicit promise that its SaaS will include new or changed features or functionality or provide customers with marketing or similar information that describes expected future updates, upgrades or enhancements to its hosted software.

In contrast to specified upgrades in a software licensing arrangement, because the customer is already accessing the entity's hosted software, the entity does not have to deliver any additional software (e.g. a new version) to the customer to satisfy the explicit or implicit upgrade promise. This has given rise to a question as to whether a promised update, upgrade or enhancement in a SaaS arrangement is:

- an additional promised service to the customer (i.e. an additional SaaS element) that is satisfied by the SaaS provider when the update/upgrade/enhancement 'goes live'; or
- merely part of the overall promise to provide SaaS; and therefore, not an additional promised good or service in the contract with the SaaS customer.

Those that assert the latter point of view state that the nature of a SaaS arrangement (at least in a multi-tenant architecture) is the customer having access to whatever version of the software the entity hosts in its multi-tenant environment. The fact that the entity communicated to a customer its intent to add features and/or functionality to its hosted software does not constitute a promise to any specific customer.

Identifying additional promises to the customer

We believe the specific facts and circumstances will affect the determination of whether communication of planned feature or functionality enhancements in a SaaS environment results in an additional promised service – i.e. a promise to provide access to those new features and/or functionalities in addition to the SaaS provider's promise of providing access to its core SaaS offering. Any one of the following three indicators would typically suggest the communication of planned feature or functionality enhancements reflects a promise to the customer:

- *The SaaS provider intends to sell the new features or functionalities on a stand-alone basis*

  If the SaaS provider intends to sell the new features or functionalities on a stand-alone basis, it generally suggests that the provision of access to those items to the customer is an additional promised service in the contract. For example, a promise to transfer a new module that the SaaS provider intends to sell to other customers independently or bundled with an entirely different suite of products from that to which the customer has access before introduction of the new module would generally be a promise to provide additional SaaS to the customer in the future – i.e. in addition to the SaaS to which the entity initially promises to provide.

- *The added features or functionalities provide new, discrete capabilities (i.e. the ability to perform tasks or functions independent of the original features or functionalities) with independent value to the customer*

  A SaaS provider may only intend to provide access to a new module or new application as part of a suite. The fact that the SaaS provider does not intend to sell access to the new module/application on a stand-alone basis does not mean promised access to that new module/application (when available) is not a promise to the customer. Regardless of whether the SaaS provider intends to sell the new features or functionalities on a stand-alone basis, if the new features or functionalities provide discrete capabilities that have independent value to the customer – i.e. independent from the existing functionalities to which the customer has access – it generally suggests that the provision of access to those new features or functionalities is an additional promised service in the contract.

— *The customer is accessing the SaaS in a single-tenant architecture*

A promise to add features or functionalities, whether explicitly or implicitly, to a hosted software application in a single-tenant architecture would generally be viewed in the same manner as a promise to provide a specified software upgrade in a software licensing arrangement – i.e. the promise to add the specified features or functionality is an additional promise specific to that customer to provide the customer with access to those added features or functionality.

If none of these indicators is present, then we believe the communication of planned feature or functionality enhancements in a SaaS environment would not normally be additional promises to the customer.

Evaluating whether additional promises are distinct

Broadly consistent with the evaluation in Question C340 relative to specified upgrades in a software licensing arrangement, we would typically expect additional SaaS functionalities that represent promises to the customer (see above) to be distinct.

Given the underlying principle of the distinct evaluation – which is to evaluate whether two or more promised items are, in effect, inputs to a single *combined* item – an additional feature/functionality that will be made available to the customer substantially after 'go-live' will typically *not* be an input to a combined item. [ASU 2016-10.BC29]

Further, the distinct evaluation considers the level of integration, interrelation or interdependence *among* promised items to the customer (in this case, the SaaS offering and the additional feature or functionality). Therefore, even if the additional feature or functionality depends on the hosted application to which the customer already has access (in the same manner additional software code in a specified update or upgrade likely just adds to existing software code to which the customer already has rights of use), the customer's ability to make substantial use of the SaaS offering before implementation of the additional feature or functionality, and the entity's ability to fulfill its promise to provide the SaaS offering before developing the additional feature/functionality, supports that the two items are not highly interrelated or highly interdependent. [ASU 2016-10.BC32]

Example C350.1

Additional SaaS features/functionalities not accounted for as an additional promise to the customer

ABC Corp. is a SaaS provider of tax preparation software – i.e. ABC provides software-as-a-service, and does not license its software. ABC's customers access ABC's tax preparation software in a multi-tenant environment. ABC enters into a three-year SaaS arrangement with Customer.

Scenario 1: No additional promise to the customer

In response to an inquiry from Customer during the contract negotiation process, ABC provides Customer with a product development plan demonstrating that by the end of Year 1 of the arrangement, ABC's software will incorporate the necessary fields and calculations to address new government regulations that come into effect during Year 2 of the ABC/Customer SaaS arrangement.

The new features will not provide any discrete functionality to users of the tax software; the new fields and calculations are an integrated part of the software being able to perform its core function – the production of complete and accurate tax returns. The new features were planned for introduction into ABC's tax software before, and independent of, the negotiation with ABC because the new regulations will affect all of ABC's tax software customers.

ABC observes that the updated features do not provide a discrete or independent functionality to any customer. Rather, these feature enhancements are necessary to keep ABC's tax preparation software current and relevant for *all* of its existing and future customers. Without the updates, ABC's software could not produce complete and accurate tax returns, which is its core function. Therefore, the updates are more about *maintaining* the utility of the software than *enhancing* the software.

As a result, ABC concludes that provision of its product development plan does not result in an additional promise to Customer to provide the features and functionalities described. This is even though the expected updates were expressly communicated to the customer in response to a direct inquiry during the contract negotiation process; and were likely something that if ABC was not committed to providing would have adversely affected ABC's chances of winning the contract.

Scenario 2: Additional promise to the customer

In response to an inquiry from Customer during the contract negotiation process, ABC provides Customer with its current product development plan, which includes introducing a new module for producing and filing UK tax returns by the end of Year 1 of the arrangement.

The new module will permit entities to produce and file UK tax returns regardless of whether they first produce the tax returns that ABC's software is already designed to produce – e.g. US federal and state returns. ABC has not yet decided whether it will sell this module independently.

ABC observes that the new UK tax return preparation module will provide a new, significant and independent functionality to its customers that does not currently exist; and that, if ABC chooses to do so, could be sold independently to UK tax filers. This, combined with the fact that the expectation of deploying a new UK module was communicated to the customer in response to a direct inquiry during the contract negotiation process, leads ABC to conclude that providing access to the UK module constitutes an additional promised service.

Because the UK module functions independently from the existing modules (which have functioned without a UK module for many years), ABC concludes that access to the existing software and access to the UK module are distinct from each other, and therefore separate performance obligations.

Other software-specific elements

Question C360

Should a platform transfer right be accounted for as an additional promise to the customer or as a right to exchange software licenses?

Platform transfers

A software arrangement may provide the customer with the right to transfer software from one hardware platform or operating system to different hardware platforms or operating systems. Platform transfer rights may be relative to a specified or an unspecified platform.

Interpretive response: If a software contract permits the customer, either explicitly or implicitly (e.g. by customary business practice), to continue using the original platform software in addition to the new platform software, the platform transfer right is accounted for as a promise to transfer an additional software license – to an additional software product. This is because the customer will be entitled to use two software products rather than one.

However, a platform transfer right that does not permit the customer to continue to use the original platform software is accounted for as a like-kind exchange if the right:

- is for a software product with no more than minimal differences; and
- does not increase the number of copies or concurrent users of the software product available under the license.

Question C80 addresses factors to consider in evaluating whether software products contain more than minimal differences.

If the contract does not permit the customer to continue to use the original platform software in addition to the new platform software – but is for a software product with more than minimal differences from the original licensed platform software – the platform transfer right should be accounted for in accordance with the right of return guidance in Topic 606. The entity treats the exercise of the platform transfer right as a return of the original platform software and a purchase of the new platform software, but not as an additional promised license in the contract.

If the platform transfer right is granted to a reseller of the entity's products, the same considerations generally apply. Therefore, that right is treated either as a return right, as a right to an additional specified or unspecified software product, or as a consignment.

Comparison to legacy US GAAP

If a software arrangement contractually permitted the customer to continue using the original platform software in addition to the new platform software, the platform transfer right was accounted for as an additional software product because the customer was entitled to two products rather than one.

The resulting accounting differed depending on whether the additional software product was specified or unspecified.

— If specified, because entities only rarely had VSOE over their software licenses, the entity deferred all revenue under the arrangement until the additional software was delivered.

— If unspecified, if the platform transfer right did not qualify for exchange accounting, the entire arrangement (including the unspecified platform transfer right) was accounted for as a subscription. The accounting under legacy US GAAP is described in Question C320 for arrangements that included rights to unspecified additional software products.

However, a platform transfer right that did not permit the customer to continue to use the original platform software was accounted for as a like-kind exchange if the right:

— was for the same software product; and
— did not increase the number of copies or concurrent users of the software product available under the license.

Products were considered to be the same product if there were no more than minimal differences among them in price, features and functions, and the products were marketed as the same product. If the platform transfer right did not qualify for like-kind exchange accounting, the right was accounted for as a return.

Platform transfer rights granted to resellers, rather than end customers, were accounted for as returns.

In general, the evaluation of whether a platform transfer right is accounted for as an additional promise to the customer, as a like-kind exchange right, or as a return right is consistent between Topic 606 and legacy US GAAP. However, if a platform transfer right is accounted for as an additional promise to the customer (specified or unspecified), it will typically be distinct from the other promised goods and services in the contract. Therefore, unlike under legacy US GAAP, it will not result in either deferral of all contract revenue until the *specified* additional software license is transferred, or recognizing revenue for the entire arrangement as a subscription (if the additional software license right is *unspecified*).

Example C360.1
Platform transfer rights

ABC Corp. enters into a contract with Customer to transfer a license to Software Product X on Platform A (X on A software) and grants Customer the right to exchange the X on A software for Software Product X on Platform B (X on B software) when-and-if available.

Scenario 1: Customer may continue to use original software

Customer may continue to use the X on A software if the platform transfer right is exercised. The X on B software has no more than minimal differences in price, features and functions from the X on A software and the two products are marketed as the same product. There are no other promises to Customer in the contract.

Because Customer is entitled to continue to use the X on A software in addition to the X on B software, the X on B software is accounted for as an additional promised software license.

ABC then concludes that the X on B software is distinct from the X on A software. ABC regularly sells licenses to the X on A software without also promising to transfer a license to the X on B software, and vice versa. In addition, the two software applications do not create a combined functionality in this contract, nor do they modify or customize one another. Consequently, ABC concludes that the two applications are each capable of being distinct – i.e. customers can benefit from each software product on its own or together with other readily available resources – and that the promises to transfer each license are separately identifiable.

Scenario 2: Customer may *not* continue to use original software

Unlike Scenario 1, Customer is not contractually entitled to continue to use the X on A software if it exercises the platform transfer right;

The X on B software has no more than minimal differences in price, features or functionality from the X on A software, and it is assumed that the platform transfer does not grant incremental user rights to Customer. Therefore, the platform transfer right is not an additional promised good or service in the contract. Instead, it is accounted for as a like-kind exchange right, which requires no additional accounting by ABC.

Example C360.2
Unspecified platform transfer rights

ABC Corp. enters into a contract with Customer to transfer a license to Software Product X on Platform A (X on A software) and grants Customer the right to exchange the X on A software for a license to Software Product X on a different operating system. The right does not expire. The different operating system is not specified in the arrangement. Customer would not retain rights to use the X on A software.

There are two promises in this contract: the promise to transfer a license to the X on A software, and an unspecified platform transfer right that does not expire.

The platform transfer right is unspecified. However, the open-ended nature of that right means that there is a high likelihood that the product to which Customer would receive a license upon exercise would have more than minimal differences from the X on A software with respect to features, functionality and price. Therefore, the platform transfer right is not an exchange right.

ABC concludes that the X on A software license and the unspecified platform transfer right are distinct from each other, and therefore separate performance obligations. ABC's evaluation of whether the unspecified platform transfer right is distinct is consistent with the analysis in Example C320.1.

Question C370

Is a sunset clause included in a contract with a customer a promised good or service? If so, is it distinct?

Sunset clauses

Under the provisions of a sunset clause, a customer is entitled to replace a software product – if the entity discontinues support of the licensed product and has migrated to a new product – provided the customer was current on its right to receive unspecified updates, upgrades and enhancements. Such a clause is also referred to as an end-of-life clause.

Interpretive response: Under Topic 606, exchange rights that allow customers to exchange one product for another of the same type, quality, condition and price are not additional promised goods or services in a contract. Therefore, if the sunset clause entitles the customer only to a replacement software product that has no more than minimal differences in price, features and functionality as compared to the licensed product, we expect that a sunset clause will not be considered an additional promise in the contract.

However, if the replacement product is expected to have more than minimal differences in price, features or functionality when the clause is triggered (or these factors are unknown), the entity needs to consider whether the right is, in-substance:

- a contingent return right (i.e. right of return that is contingent upon the end-of-life of the existing product); or
- a specified when-and-if available upgrade right.

All facts and circumstances need to be considered when determining the accounting for such provisions. Entities that include sunset clauses in their contracts should consider including language specifying that replacement products will have no more than minimal differences in price, features and functionality.

Comparison to legacy US GAAP

The legacy US GAAP accounting guidance with respect to what constituted an exchange, and how to account for an exchange, is essentially the same as that in Topic 606.

If the sunset clause is deemed to provide a specified upgrade right, the accounting effect of that conclusion under Topic 606 differs substantially from the accounting effect of that conclusion under legacy US GAAP (see Question C340).

Customer options

Excerpt from ASC 606-10

>> Customer Options for Additional Goods or Services

55-41 Customer options to acquire additional goods or services for free or at a discount come in many forms, including sales incentives, customer award credits (or points), contract renewal options, or other discounts on future goods or services.

55-42 If, in a **contract**, an entity grants a **customer** the option to acquire additional goods or services, that option gives rise to a **performance obligation** in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes **revenue** when those future goods or services are transferred or when the option expires.

55-43 If a customer has the option to acquire an additional good or service at a price that would reflect the **standalone selling price** for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those cases, the entity has made a marketing offer that it should account for in accordance with the guidance in this Topic only when the customer exercises the option to purchase the additional goods or services.

Topic 606 states that an option for additional goods or services (such as a renewal option) constitutes a separate performance obligation if the option gives the customer a *material right* that it would not receive without entering into that contract – i.e. the customer effectively pays the entity in advance for the right to acquire future goods or services.

Questions C380 – C490 address what constitutes a customer option, and whether a customer option is a performance obligation because it provides the customer with a material right. Other matters with respect to accounting for customer options that are determined to provide the customer with a material right – e.g. the allocation of consideration to material rights, and accounting for the exercise of a material right – are addressed in Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract; Material rights in this handbook.

Comparison to legacy US GAAP

The evaluation of whether a discount offered on future purchases provides a customer with a material right is similar to (but not the same as) legacy US GAAP and could lead to different units of accounting than under legacy US GAAP. Under legacy US GAAP, an offer of a discount on future purchases of goods or services was generally separately accounted for if it was significant and incremental to both:

- the range of discounts typically given in comparable transactions; and
- the range of discounts reflected in the pricing of other elements in that contract.

In assessing whether an option gives the customer a material right under Topic 606, the discount on future purchases of goods or services is considered to be a separate performance obligation if that discount is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market. The discount offered does not need to be incremental to the discount given for other goods or services in the contract to be a material right, which is different from the requirements in legacy US GAAP.

This change could result in the identification of more options as material rights under Topic 606 than under legacy US GAAP.

Question C380

Are usage (or transaction) based fees in a software licensing arrangement variable consideration or an 'optional purchase'?

Interpretive response: Generally, it will be variable consideration. This is because, in a software licensing arrangement, the nature of the entity's promise to the customer is to grant the customer a right to use the entity's software (i.e. a license). Once that right of use is transferred to the customer (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*), the entity does not have to transfer additional rights of use (or other goods or services) to the customer for them to be able to use that right – e.g. process transactions using the software.

That the customer will pay for the license based on its usage thereof – e.g. number of transactions processed or sales of the customer's products that use the entity's software – rather than a fixed fee, does not change the nature of the arrangement; fundamentally, the promise to the customer is to grant the software license. Once the customer controls its right to use the software, the customer's subsequent use of that right does not involve the customer undertaking a decision to make an additional purchase from the entity, and therefore each usage is not an optional service. Instead, the usage-based fee is variable consideration related to the transferred software license.

Question C385

Are usage (or transaction) based fees in a SaaS arrangement variable consideration or an 'optional purchase'?

Interpretive response: It depends. In general, we believe that if the nature of the promise is fundamentally for the entity to provide unlimited continuous access to its hosted application, a customer's use of its access to the hosted application does not involve the customer undertaking a decision to make an additional purchase from the entity. In that case, each usage of the SaaS is not the purchase of an optional service.

In contrast, a SaaS arrangement could be structured in a manner similar to many service arrangements in which a service provider agrees to perform a defined task if called upon to do so for a specified fee. For example, a customer may have the right under a contract to upload data to a hosted application and have that application produce one or more reports using that data for a fee specific to that request. The arrangement in that case may involve little more than the promise that if the customer accesses the service via the internet and uploads the data, the hosted application will return the requested report and, in that case, the customer makes an affirmative decision to acquire a report using the system and pay the required fee. Similarly, the customer could contract for a specified quantity of services (e.g. process a specified number of transactions) and have the option to acquire incremental distinct services (e.g. additional transactions for an additional fee once that quantity has been diminished.

Determining the nature of the promise to the customer in a SaaS arrangement may require significant judgment. The following indicates the nature of the promise is one to stand ready or provide a single continuous service and therefore the usage-based fee is variable consideration.

— The entity is continuously transferring control of the service to the customer by providing access to the services and the customer's usage occurs as the entity is transferring control.

— The customer's increase in usage does not change the entity's obligation or provide the customer with incremental rights to services for the remainder of the term (i.e. the obligation to the customer does not diminish).

— The customer is not making a separate purchasing decision that results in an entity having additional obligations to the customer.

In addition, we believe the following factors could also suggest that the arrangement is one to provide a service of continuous access to a hosted application rather than providing the customer an option to obtain incremental services – e.g. production of a specific report or processing of a specific transaction – that merely uses software hosted by the entity or a third party engaged by the entity to provide.

- The customer is not required to execute ***an additional contract***, whether characterized as a purchase order, an addendum, an amendment, a modification of the existing contract, or a termination of the existing contract and creation of a new contract. These actions typically suggest an affirmative, additional purchasing decision by the customer to acquire incremental services.
- The entity maintains ***significant infrastructure***, particularly *dedicated* infrastructure, to fulfill the terms of the contract.
- The presence of a ***service-level provision*** anchored to availability of the SaaS. For example, a provision that entitles the customer to service-level credits if system or application availability is less than XX% during the measurement period suggests the nature of the promise to the customer is continuous access to that system or application.
- The presence of a ***significant fixed fee*** component (regardless of whether it is payable upfront or over time), particularly if that fixed fee is a significant portion of the overall consideration the entity expects to earn from the contract, suggests that the customer ascribes significant value to the availability of the system or application, not just on the ability to obtain specified outputs. A significant fixed fee component may be written in the contract as a guaranteed transaction- or usage-based minimum.
- ***Usage of the hosted system or application is outside the control of the customer.*** For example, if the arrangement between the entity and the customer is to process transactions when-and-as they are initiated in the system, but the *customer's customers* initiate those transactions in the system, it implies that each transaction processed is *not* an 'optional purchase'. This is because the customer has no role in deciding whether transactions are initiated in the system.

Example C385.1
SaaS usage based fees

ABC Corp. enters into a contract with Customer to provide SaaS that allows Customer to process transactions. Customer does not have the right to take possession of the hosted software.

Scenario 1: Usage-based fees are variable consideration

ABC provides Customer with continuous unlimited access to its SaaS that Customer is obligated to use to process an unspecified number of transactions as they occur. ABC must provide access to the SaaS regardless of the number of transactions processed and the number of transactions processed by ABC is outside of both ABC's and Customer's control. ABC charges customer $10 per transaction processed.

ABC concludes that the nature of the promise is one of standing ready as ABC is obligated to provide continuous access to its SaaS to Customer and Customer has the ability to use an unlimited amount of SaaS to process an unlimited amount of transactions over the contract term and those rights do not diminish.

ABC also concludes that the transaction fees are variable consideration as the Customer compensates ABC based on its usage of the SaaS rather than Customer acquiring additional rights. This is evidenced by the following:

— Customer is not required to exercise or execute an additional contract.
— Customer's usage is outside of its control as the number of transactions is dictated by Customer's customers.
— Customer's usage resets after each transaction (i.e. rights do not diminish).
— Customer does not obtain any incremental rights as a result of each transaction being processed because at contract inception it obtained a present right to process an unlimited number of transactions.

Scenario 2: Overages are variable consideration

Assume the same facts as scenario 1 except that ABC charges Customer a fixed fee of $300,000 and an overage fee of $10 for each transaction over 10,000 in a contract year.

ABC concludes that the nature of the promise is one of standing ready as ABC is obligated to provide continuous access to its SaaS to Customer and Customer has the ability to use an unlimited amount of SaaS to process an unlimited number of transactions over the contract term and those rights do not diminish.

ABC also concludes that the overage fees are variable consideration as the Customer compensates ABC based on its usage of the SaaS rather than Customer acquiring additional rights. This is evidenced by the following:

— Customer is not required to exercise or execute an additional contract.
— Customer's usage is outside of its control as the number of transactions is dictated by Customer's customers.
— Customer's usage resets after each transaction (i.e. rights do not diminish).
— Customer does not obtain any incremental rights as a result of each transaction being processed because at contract inception it obtained a present right to process an unlimited number of transactions.
— Customer pays a significant fixed fee.

Scenario 3: Overages as optional purchases

ABC provides transaction processing services through its SaaS platform. ABC contracts with Customer to process 100 transactions for $10 per transaction. Customer's rights to the 100 transactions expires as each transaction is consumed and Customer has the option to acquire additional transactions for an additional $10 per transaction. In order to receive processing for more than 100 transactions, Customer must execute the contractual option and the ability to obtain this additional processing is in Customer's control (i.e. in contrast to Scenarios 1 and 2, Customer is not obligated to process transactions with ABC based on the actions of its customers and can make a decision to process (or not to process) incremental transactions).

ABC concludes that the nature of the promise is to provide a service of processing 100 transactions rather than a stand-ready obligation or continuous access to its SaaS platform because there is a specified quantity of services that significantly diminish over the contract term and the network provides no benefit to the customer beyond the processed transactions.

ABC concludes the additional transactions are optional purchases based on the following.

- Customer has the choice to purchase additional services (the transactions) and until that decision is made ABC is not obligated to perform any services.
- Each transaction processed is a distinct service that was not contracted for by Customer in the initial contract.
- Each additional transaction changes Customer's rights because Customer cannot further use ABC's services without making the decision to purchase additional transaction processing.
- While ABC has substantial infrastructure, it is not dedicated to Customer.

Question C390

Is a provision permitting a customer to obtain additional copies of a software product subject to the customer option guidance or does it describe a usage-based royalty?

Interpretive response: A software license is just an example of a promised good or service. Consequently, a provision that permits a customer to obtain *additional software licenses* (whether characterized as users, seats or otherwise) is subject to the same customer option guidance as any other provision that permits a customer to obtain additional goods or services that are not licenses. In contrast, as outlined in Question C40, a customer's usage of a license that it already controls is not the exercise of a customer option – i.e. the customer is not making an 'optional purchase'.

Whether a contract provision *permitting* a customer to obtain additional copies of a software product is an option to acquire additional software licenses is fundamentally the same question as whether a *promise* to provide multiple copies of licensed software is a promise to transfer multiple software licenses (see Question C40). If a *promise* to transfer multiple copies of a software product is considered a promise to transfer multiple software licenses to the customer, a right to acquire those same copies is an option to acquire additional software licenses.

Consequently, in determining whether a contract provision describes an option to acquire additional licenses to a software product or a usage-based fee, an entity must determine whether that contract provision, however characterized:

- describes a right for the customer to acquire incremental *capabilities to make use* of the software – for which, by nature, the customer makes an additional purchasing decision when it decides to acquire those incremental rights; or
- merely describes how the customer will compensate the vendor for the use of the rights and capabilities that it already controls.

This determination will frequently require judgment because the two types of provisions are often worded similarly in contracts. However, we believe the following are some factors to consider in making this distinction (none of which should be considered individually determinative).

- Whether the customer is required to execute an additional contract – whether characterized as an addendum, an amendment, or papered as either a modification of the existing contract or a termination of the existing contract and creation of a new contract. This typically suggests an affirmative, additional purchasing decision to acquire incremental rights and capabilities to use the entity's software that the customer does not already control. A customer would not be expected to enter into an additional contract merely to exercise rights that it already controls under an existing contract. In fact, as outlined in Question C380, usage of existing rights of use is often outside the control of those making purchasing decisions. For example, usage may be triggered by the customer's customers, or may be the result of employees far from the procurement process using tools that they have been provided to process transactions, conduct research or produce reports.

- Whether the customer is required to make an affirmative request of the vendor – e.g. to deliver additional copies or additional software keys. This may suggest that the customer is making an affirmative decision to request additional rights or capabilities from the vendor. A customer would not, in contrast, typically enter into a contract that requires such affirmative action from the vendor merely to exercise the rights that it already controls; any such provision would likely call into question whether the customer actually controls those rights.

- An incremental right or capability usually exists concurrently with the existing right(s) that have previously been transferred to the customer. For example, in Example 61B in Topic 606, the customer obtains the incremental right to embed the entity's software into another class of its consumer products one year after obtaining the initial right to embed the entity's software in the first class of consumer products. That right increases the customer's rights under the contract and the customer's ability to derive benefit from use of the software. The example concludes that the customer now has rights to embed the vendor's software into two classes of consumer products rather than only the one. [606-10-55-399K – 55-399O]

- For instance, a customer's utilization of software may be directly linked to the number of users or seats the customer has rights to deploy. If that customer has the right to increase from 50 user or seat licenses to 75 user or seat licenses, it has the present right (at its option) to significantly increase its capabilities from use of the software. Those incremental capabilities from the additional 25 user or seat licenses will exist together with the capabilities from the original 50 user or seat licenses.

— In contrast, usage typically occurs and is consumed – e.g. a transaction is processed, a call is fielded, or a product is sold that includes the embedded software. One 'usage' is not additive to another.

— An incremental right, once obtained, will frequently be granted for the remainder of the term of the original right(s) of use and/or have to be canceled. For example, a customer that decides to add 100 user licenses may have a continuing obligation to pay for those additional licenses (e.g. additional periodic license fees and/or PCS fees) until it elects to terminate those rights. Termination includes not electing to renew; Topic 606 does not distinguish between decisions to renew and decisions not to terminate, or vice versa. [ASU 2014-09.BC391]

— In contrast, usage typically occurs and resets each measurement period i.e. the usage occurs and ends on its own. For example, while an entity might expect a customer to process at least a minimum number of transactions during a given measurement period, those transactions occur and end, and it is only new transactions that trigger additional usage-based fees to the entity in the next measurement period.

Comparison to legacy US GAAP

The requirement to account for a significant incremental discount on additional licenses of a software product for which one or more licenses have already been transferred to the customer is a change from the legacy US GAAP. Legacy US GAAP provided an exception to its guidance on accounting for significant incremental discounts as additional elements to a software arrangement for discounts offered on additional copies of software products for which the product master had already been delivered to the customer.

With respect to identifying contract provisions as options to acquire additional licenses or as usage-based fees, in general, the distinction was not important under legacy US GAAP. Because legacy US GAAP provided the above exception, the accounting that would result from either conclusion (i.e. that a provision was an option to acquire additional licenses or a usage-based fee) was the same. Entities generally recognized usage-based fees when the customer's subsequent usage occurred and recognized revenue from customer options when the option was exercised (assuming no additional deliveries of software were required).

Consequently, there was little guidance in legacy US GAAP, or developed interpretively, distinguishing between options and usage-based fees. That being said, Subtopic 985-605-55 included guidance that usage-based fees were determined by applying a constant multiplier to the frequency that the licensee used the software – e.g. customer call center software wherein a fee of $.01 is charged for each call handled.

Under Topic 606, the distinction between options and usage-based fees matters:

— an option to acquire additional software licenses may provide the customer with a material right; while

— usage-based fees associated with software licenses will, consistent with legacy US GAAP, generally be recognized when the customer's usage occurs (due to the sale- or usage-based royalties guidance for licenses of intellectual property – see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*).

Topic 606 does not define a 'usage-based fee'. Therefore, judgment is necessary to distinguish between customer options to acquire additional software licenses and usage-based fee provisions.

Example C390.1

Option to acquire additional licenses vs usage-based fee

Software Vendor S enters into a contract with Customer T to license its on-premise software used to route customer service tickets to the appropriate departments and locations for four years. Under the contract, 50 concurrent users are permitted to use the software. With 50 concurrent users, Customer T can route approximately 100,000 tickets each week.

Per the contract, Customer T will pay a fixed, upfront fee of $500,000 and will also pay $0.50 per ticket routed using the software. The contract permits Customer T to increase its concurrent user maximum for the duration of the license period in blocks of five concurrent users at a rate of $4,000 per block. That $4,000 rate decreases throughout the license period in proportion to how much of the license period remains at the time concurrent users are added – e.g. the fixed, incremental fee for a five-user 'block' when there are two years remaining in the license period would be $2,000.

The per ticket fee of $0.50 applies to all tickets routed using Software Vendor S's software, regardless of how many concurrent users are presently permitted to use the software.

Software Vendor S concludes that:

— the provision permitting Customer T to add concurrent users is a customer option to acquire additional licenses to Software Vendor S's software; and
— the $0.50 per ticket fee is a usage-based royalty that links the contract consideration to the customer's use of the license rights it has transferred initially.

Customer T already controls the right, upon transfer of the original 50 concurrent user rights, to process up to 100,000 tickets per week. There are no further rights for Software Vendor S to transfer to Customer T, and it is not an optional purchase by Customer T, reflective of an additional purchasing decision, to exercise the rights it already controls.

In contrast, the addition of concurrent users increases Customer T's ability to derive benefit from use of the software by increasing its capability to route customer service tickets on a basis proportional to the incremental user rights it obtains; those increased rights are additive to and exist concurrently with those it already controls. The addition of concurrent users therefore represents the acquisition of additional licenses to use Software Vendor S's software, which Customer T undertakes an additional purchasing decision to acquire.

Example C390.2
User-based provision that is a usage-based fee

Software Entity R enters into a three-year software licensing arrangement with Customer W for its research application whereby Customer W will pay Software Entity R a fixed upfront fee of $10,000 plus a $50 fee for each user that logs into the application each month.

If a user logs into the system each of the 36 months of the arrangement, Customer W will owe Software Entity R $1,800 for that user, on top of the fixed license fee paid upfront. All users require a unique username and password, and Software Entity R has various audit rights to help ensure all users are registering.

Software Entity R concludes that the user-based fee is a usage-based royalty, rather than a customer option to acquire incremental rights (beyond those transferred at contract inception) to use the research software.

Software Entity R considers the following in making this judgment.

— A Customer W employee does not have to obtain anything from Software Entity R to use the software. It can create a username and password and use the software under that username and password without notifying or contacting Software Entity R.

— Customer W does not execute an additional contract with Software Entity R when one of its employees creates an account or uses the research software.

— A user's usage in a given month, which triggers the user-based fee, does not create an ongoing obligation for the remainder of the license term or require an affirmative action to cancel. Rather, it resets each month. For example, if User #1 uses the research software in Month 1 of the arrangement and never uses it again, Customer W will only owe the $50 user-based fee for User #1 for Month 1.

— A user's use of the system does not create an incremental right that increases the overall capabilities of the software to Customer W in the way it did in Example 390.1. The rights that Customer W controls for its employees to use Software Entity R's research software are not different in a month in which 100 Customer W employees use the software versus a month in which 10 or 500 Customer W employees use the software.

Example C390.3
Metric-based provision

Software Entity Q enters into a perpetual software licensing arrangement with Customer G for its accounting application. Customer G's license fee is initially determined based on its annual revenues. At contract inception, the fee (to be paid upfront) of $100,000 is based on annual revenues of $100 million.

If Customer G's annual revenues increase beyond defined thresholds, Customer G will pay additional license fees. For example, Customer G will owe an additional license fee if its annual revenues surpass $125 million, a further fee if they then surpass $150 million, etc.

Software Entity Q concludes that the revenue-based fee provision does not represent a customer option to acquire additional licenses. This is because while Customer G is likely to make greater use of Software Entity Q's software as it grows (evidenced by its increasing revenues), at the point in time the license is transferred to Customer G, Customer's G license is already capable of supporting Customer G as a $125 million or $150 million company.

Therefore, the additional fee does not represent an option for Customer G to acquire additional rights and capabilities that it does not control when the initial license is transferred. Rather, the revenue-based fee provision represents an additional fee based on Customer G's usage – based on a revenue metric rather than a direct measure of usage such as transactions processed – of those rights and capabilities.

Question C400
Is a provision permitting a customer to add users (or seats) to a SaaS subscription a customer option or variable consideration?

Interpretive response: It depends. We believe determining whether a provision permitting the customer to add users or seats to a SaaS arrangement describes a customer option or a usage-based fee involves fundamentally the same considerations as outlined in Question C390 and evaluating usage based fees in a SaaS arrangement in Question C385.

If the additional user or seat is an option to acquire an additional distinct good or service that is incremental to the rights to the SaaS the entity currently has, then the provision is generally a customer option. Factors that indicate the provision is an optional purchase include but are not limited to:

- the nature of the promise is to provide SaaS for a defined number of users or seats over the contract term and the option provides incremental rights;
- the customer's rights are limited to the number of users or seats until the option is exercised;
- the customer option requires a separate purchasing decision to acquire incremental users or seats;
- the additional users or seats once obtained are purchased for the remainder of the contract term; and

— the provision of service for each user or seat is distinct from another user or seat.

If the additional user or seat provision is a payment mechanism that describes the customer's right to use the service it has already obtained, it is generally variable consideration. Factors that indicate the provision is variable consideration include but are not limited to:

— the nature of the promise is to provide continuous access to SaaS for an unlimited number of users or seats over the contract term;
— the customer's rights are unlimited;
— the number of users or seats resets each measurement period (i.e. the customer's rights do not diminish and the amount of users or seats in one contractual period does not affect the payments in the next contractual period); and
— the benefit from the additional user or seat is consumed and not attributable to the remainder of the contract term.

Example C400.1
SaaS user based fees

ABC Corp. enters into a contract with Customer to provide Customer with access to its hosted software application for three years. Customer does not have the right to take possession of the hosted software.

Scenario 1: User based fees are optional purchases

ABC provides Customer its SaaS for 100 users for $100,000. Customer has the ability to exercise an option in the contract to add a user for the remainder of the contract term for an additional $1,000 pro-rated for the remainder of the contract term.

ABC concludes that the incremental user-based fee represents an optional purchase rather than variable consideration because each incremental user represents Customer acquiring additional rights as follows:

— The nature of the SaaS is to stand ready but on a per user basis rather than for the contract as a whole. That is, the nature of the promise is to provide stand-ready access to a contractually specified number of users.
— Customer is required to execute a contractual option to acquire an incremental user.
— Customer obtains incremental rights because before exercising the option it did not have a present right for the incremental user to access the SaaS.
— Customer's rights to the incremental user are granted for the remainder of the contract term rather than resetting.

ABC would evaluate whether the option for incremental users is a material right.

Scenario 2: User based fees are variable consideration

ABC provides Customer with unlimited access to its SaaS and charges Customer $10 per user per month. The number of users resets each month.

Customer does not execute an additional contract for each user and ABC bills Customer based on the number of users each month.

ABC concludes that the user-based fees are variable consideration as the Customer compensates ABC based on its usage of the SaaS rather than Customer acquiring additional rights. This is evidenced by the following:

- The nature of the promise is one of standing ready as ABC is obligated to provide continuous access to Customer and Customer can use an unlimited amount of SaaS over the contract term.
- Customer is not required to execute a separate contract to add a user.
- Customer does not obtain any incremental rights for each user as it already had a present right to unlimited users.

Customer's usage resets each month and the usage for each month is consumed rather than acquiring rights for the remainder of the term.

Question C410

Are renewal options for services promised goods or services in a contract?

Interpretive response: A renewal option for services (e.g. SaaS, PCS or hosting services in a software licensing arrangement) gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. It does not create enforceable rights and obligations for the parties, and therefore a renewal option does not represent a promised service in the contract.

Further, as described in the basis for conclusions to ASU 2014-09, a three-year contract that allows the customer to cancel at the end of each year is no different from a one-year contract with two one-year renewal options – provided there is not a substantive termination penalty the customer must pay if it elects an option to cancel. If a customer must pay a substantive termination penalty to cancel a service contract, the contracted service period includes all of the periods for which, if the customer canceled the service, the termination penalty would apply. This issue is addressed in further detail in *Chapter B – Step 1: Identify the contract with the customer*. [ASU 2014-09.BC391]

However, a renewal option (or an option to continue a service contract by not terminating) does create an additional performance obligation in a contract if it provides the customer with a material right that it could not otherwise obtain without entering into the contract. A renewal option that does *not* provide the customer with a material right is not accounted for as part of the original contract; rather, it is treated as a new contract when it is exercised by the customer. A renewal option usually provides the customer with a material right if the renewal price for the services is lower than the price for the same services the entity offers to similarly situated customers *that have not entered into a contract with the entity previously*.

A renewal price may be discounted either explicitly or implicitly. A renewal price is discounted explicitly when there is a stated renewal price in the contract that is lower than the price for the same services that the entity offers to similarly situated customers that have not entered into a contract with the entity previously. An implicit discount might arise when the customer pays a nonrefundable upfront fee in connection with the initial services contract that it does not have to pay again in order to renew the service; for example, a fee that is not a payment for a promised service, such as implementation services. See further discussion below and Questions D20 on upfront fees.

Some have questioned whether an entity considers the renewal option price as compared to the stand-alone selling price for the goods or services at contract inception or, instead, to an expected renewal price at the end of the contracted service period. In general, we do not believe a renewal option priced at the contract inception stand-alone selling price of the service provides a material right to the customer. This is because, even though this may not occur frequently, the customer could exercise the option immediately after contract inception. We do not believe an entity is required to forecast what the stand-alone selling price for a good or service will be in the future and, in any event, believe that any such forecast would be potentially unreliable given that economic circumstances could change significantly or new competition could enter the marketplace that render any previous expectations obsolete.

Evaluating upfront fees

The objective of evaluating whether an upfront fee provides a material right is to identify the periods that the customer benefits from not having to pay another fee upon exercising a renewal option. The period the customer benefits from the renewal includes only those periods that the fee influences the customer's decision to exercise its option. [TRG Agenda Paper No. 32]

The entity considers both quantitative and qualitative factors to evaluate the presence of a material right. We believe the following factors should be considered to identify the periods (if any) for which a nonrefundable upfront fee provides a material right.

— **The renewal price compared with the price in the initial contract with the upfront fee.** The significance of the upfront fee and amounts paid for the initial services compared to renewals could influence a customer's decision to renew. The customer may be economically compelled to renew based on its initial investment.

— **The availability and pricing of service alternatives.** For example, if the customer could readily obtain similar services without having to pay an upfront fee, the initial payment may not be an incentive for the customer to renew because it could easily obtain services elsewhere at prices similar to the renewal price.

— **History of renewals.** If the entity has a strong history of renewals, it might indicate that the upfront fee provides an incentive for the customer to exercise its renewal option. For example, an entity might look at the average customer life or periods where the customers renew at a high rate.

If the fee provides a material right, the period the customer benefits from the fee may be shorter than the average customer life. This is because there may be many factors other than the upfront fee that influence a customer to renew a contract. For example, the quality of service and convenience of not changing providers could influence the customer to renew, but those renewals would not mean the customer was provided a material right when it paid the upfront fee. As a consequence, significant judgment will be required to determine the period for which a material right is present.

See Question E390 and Example E390.1 for further information on allocating the transaction price to material rights as a result of nonrefundable upfront fees.

Example C410.1
SaaS renewal option

Scenario 1: Option to renew is a material right

SaaS Provider A enters into a contract with Customer D to provide D access to its payroll processing software through a SaaS arrangement. Customer D can use the software through a web-based interface but cannot download the software for use offline. Customer D pays the contracted SaaS fees on a quarterly basis, in advance.

The arrangement is for one year, for a contracted rate of $1,200. Customer D can renew the contract for additional one-year periods at SaaS Provider A's then-current market rate for similar customers.

Customer D is required to pay a $200 non-refundable upfront fee to SaaS Provider A at contract inception but will not have to make that payment again if it renews the contract for additional one-year periods.

The $200 fee is not a payment for an additional good or service (i.e. in addition to the SaaS). This is because, while SaaS Provider A undertakes activities to set up the customer's access to the software application, those activities do not provide any incremental benefit to the customer. They are merely necessary for Customer D to be able to access the SaaS promised in the contract. As a result, in substance, the fee for the contracted one-year period of service, which is the only promised good or service in the contract, is $1,400.

SaaS Provider A concludes that the option to renew the arrangement provides Customer D with a material right.

In reaching this conclusion, SaaS Provider A considers that there are factors other than payment of the upfront fee that will likely influence Customer D's decision to renew the arrangement after the one-year period – e.g. consideration of costs incurred by Customer D to migrate data to the SaaS solution or train HR employees, SaaS Provider A's performance and customer service and the availability/cost of suitable alternatives. However, the upfront fee of $200 is quantitatively material enough to the contracted SaaS fee of $1,200 such that payment of that amount upfront provides a material right to Customer D compared to other similar customers that are not currently customers of SaaS Provider A that would have to pay that $200 fee to obtain access to the SaaS. That investment would be expected to affect the customer's decision about whether to renew the arrangement independent of the other factors that would also typically influence Customer A's renewal decision.

Scenario 2: Option to renew is *not* a material right (1)

Assume the same facts and circumstances as Scenario 1 except that the committed contract term is three years, rather than one year. Therefore, the contracted fee is $3,800.

SaaS Provider A concludes that the payment of the $200 upfront fee does not provide Customer D with a material right with respect to renewal of the SaaS – i.e. the ability to renew the contract after three years without having to pay a second upfront fee is not a material right.

In reaching this conclusion, SaaS Provider A considers the effective annual SaaS fee for the initial three-year contract of $1,267 ($3,800 ÷ 3 years) versus the annual renewal price of $1,200. It concludes that that difference, and payment of the upfront fee three years ago, are not likely to significantly affect Customer D's decision to renew the SaaS.

Given the long-term nature of the initial SaaS period, other factors are more likely to significantly influence Customer D's decision to renew the SaaS. These factors include the costs Customer D would incur to transition to another alternative, the availability/cost of a suitable alternative and SaaS Provider A's performance under the initial arrangement (e.g. service uptime versus downtime and performance in providing technical support).

Scenario 3: Option to renew is *not* a material right (2)

Assume the same facts and circumstances as Scenario 1, except that there is no upfront fee and Customer D has the option to renew the SaaS at a price of $1,200, consistent with the fee for the committed one-year term.

The price of $1,200 for the renewal period represents the stand-alone selling price of the SaaS at contract inception but is likely to be less than the renewal date stand-alone selling price to a new, similar customer. This is because SaaS Provider A has been increasing its one-year contract pricing by approximately 5% each year over the last seven years; and expects to continue to do so, because its market share and reputation has grown in the marketplace and in order to keep its fees paced with inflation and other increasing costs.

The option in this scenario does not provide Customer D with a material right. Even though the stand-alone selling price of the SaaS is *expected* to increase during the term of the arrangement based on historical pricing changes and current plans of SaaS Provider A management, Customer D could elect to exercise the renewal option immediately after contract inception. At that point, the renewal price is the same as the stand-alone selling price of the SaaS.

Question C411

Is a retroactive discount earned once a customer has completed a specified volume of optional purchases subject to the guidance on material rights?

Interpretive response: No. Volume discounts (or rebates) that are retroactive are accounted for as variable consideration because the final transaction price is unknown until the customer completes (or fails to complete) the specified volume of purchase. See *Chapter D – Step 3: Determine the transaction price* and Questions C380, C385, C390 and C400 on distinguishing between contracts with variable consideration and optional purchases.

Question C412

Is a prospective discount earned once a customer has completed a specified volume of optional purchases subject to the guidance on material rights?

Interpretive response: Yes. A prospective volume discount (or rebate) earned once a customer has completed a specified volume of optional purchases is not variable consideration. Therefore, the potential discount or rebate on the optional goods or services needs to be evaluated for the presence of a material right. Such discounts are not variable consideration because they do not change the consideration for the goods or services transferred under the current contract. See Questions C380 through C400 on distinguishing between contracts with variable consideration and optional purchases.

Question C413

Does the practical expedient for immaterial promises apply to customer options?

Interpretive response: No. Topic 606 allows an entity to forgo assessing whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer.

However, this exception does not apply to the evaluation of customer options. Therefore, even if a customer option is immaterial in the context of the contract, an entity evaluates whether it conveys a material right. This is because customer options may accumulate over time across many contracts and that accumulation feature may cause an option that is immaterial in the context of one contract to be material to the customer. [606-10-25-16B]

Question C420

When assessing the amount of an incremental discount offered to a customer, should the entity look to the high-end of any "range of discounts typically given for those goods or services to that 'class of customer' in that geographical area or market", to the midpoint of that range or the median, or some other amount such as the mean?

Interpretive response: We believe entities should adopt a reasonable approach and apply that approach on a consistent basis. Depending on the circumstances, any of those might be a reasonable approach to determine the incremental discount of a customer option.

Question C430

How should an entity evaluate if an option provides the customer with a material right when the stand-alone selling price of the good or service subject to the option is highly variable or uncertain?

Interpretive response: Determining if a material right exists for options to purchase licenses of IP or other products for which the stand-alone selling price is highly variable or uncertain may require significant judgment. This is because a comparison of the option price to *a* stand-alone selling price (or even a relatively narrow range of stand-alone selling prices) is not possible.

Entities need to consider all relevant and available evidence in determining whether the purchase option is a material right in these circumstances, and we believe that there may be multiple, acceptable approaches to undertaking this evaluation.

— One example of an approach we believe is acceptable is to analyze the option price against a range of stand-alone selling prices for that good or service established in previous contracts. This is even if those stand-alone selling prices were established using a residual approach (including where that license was part of a 'residual bundle' of goods or services).

— Another approach we believe is acceptable is to evaluate whether the purchase option provides a discount to the customer that is incremental to the range of discounts reflected in the pricing of the other promised goods and services in the contract (e.g. discounts from list price offered on the promised goods or services in the contract).

The implementation guidance in Topic 606 does not contain the notion that existed in legacy US GAAP that a 'more-than-insignificant discount' must be 'incremental to the range of discounts reflected in the pricing of the other elements of the arrangement'. Therefore, we do not believe the range of discounts reflected in the pricing of the other promised goods or services in the contract should influence the determination of whether an option provides the customer with a material right *except* when the stand-alone selling price of the good or service that is the subject of the option is highly variable or uncertain. In that *limited* circumstance, we believe consideration of the pricing of the promised goods and services in the contract is a reasonable approach because a comparison to the stand-alone selling price of the good or service (as per paragraph 606-10-55-43) would be meaningless *because* the stand-alone selling price is highly variable or uncertain.

In any approach where the entity's established list prices are a data point (including the above examples), we would expect the entity's established list prices to be substantive. This means that changes to the price list must be subject to the entity's effective internal controls (including who can authorize its updating) and there is a systematic process for any triggers resulting in adjustments to the price list.

Whatever approach an entity adopts to make this judgmental evaluation, we expect it to be applied consistently in similar circumstances.

Example C430.1

Evaluating whether an option for a good or service with a highly variable stand-alone selling price grants a material right to the customer

ABC Corp. sells a software license for Product A along with technical support and rights to when-and-if available updates/upgrades (i.e. PCS) for one year to Customer XYZ. The contract also includes an option to purchase a license for Product B at a 65% discount from the published list price of $1,000,000 (i.e. for $350,000).

The contract price for the license to Product A and the related PCS (which is based on a percentage of the stated license fee) are discounted 50% from the entity's price list. ABC's price list is substantive and well controlled.

Product B has been licensed to 25 similar customers in the United States within the last few months, always bundled with technical support and unspecified update/upgrade rights. ABC has an observable stand-alone selling price for its technical support and unspecified update/upgrade rights (as a PCS bundle), but has determined that the stand-alone selling price for a license to Product B is highly variable. Therefore, ABC has used the residual approach to estimate the stand-alone selling price for Product B in each of its 25 previous contracts that included a license to Product B.

Alternative 1

ABC compares the discount offered on the license to Product B in its 25 previous license sales, calculated as the difference between the estimated stand-alone selling prices established through the residual approach and the then-current list price to the discount from the current list price being offered to XYZ.

From this process, ABC determines that the normal range of discounts it has previously provided from the list price on licenses of Product B is 30% to 50%. Therefore, the 65% discount being offered from list price on the option to license Product B provides Customer XYZ with a material right. This is because it is incremental to the range of discounts (30% to 50%) previously provided for Product B to similar customers.

Alternative 2

ABC compares the discount from list price offered on the license to Product B of 65% to the 50% discount from list price provided in the same contract with XYZ on the license to Product A and related PCS. As a result, ABC concludes that the incremental discount (i.e. 15%) on the option to purchase a license to Product B provides XYZ with a material right. ABC will estimate the stand-alone selling price of the option based on the guidance in paragraphs 606-10-55-44 – 55-45.

Note:

If the discount from list price offered on the license to Product B was 50% (or less), ABC would have concluded that the option to purchase a license to Product B did not provide Customer XYZ with a material right.

Question C440

Does a customer option to convert a term software license into a perpetual license represent an additional promised good or service in the contract?

Interpretive response: A customer option to convert a term software license into a perpetual license represents an additional promised good or service in the contract *only* if the option provides the customer with a material right. In that case, the material right is an additional performance obligation in the contract.

A perpetual license to a software product is a different good from a term license to the same software product. Consequently, an option to acquire a perpetual license to a software product already subject to a term license is, fundamentally, no different from an option to acquire a perpetual license to a *different* software product not already subject to a term license.

Question C430 discusses how an entity should evaluate whether an option to acquire a software license with a highly variable or uncertain stand-alone selling price provides the customer with a material right. If the stand-alone selling price for the perpetual license is *not* highly variable or uncertain, the considerations about whether the option provides a material right to the customer are no different from any customer option to acquire any other good or service.

If the customer exercises its option to convert a term license to a perpetual license, and that perpetual license is distinct – i.e. the option is not exercised together with services that are not distinct from that license, such as services to customize the licensed software – the fee attributable to the perpetual license cannot be recognized until after the end of the current term license period. For example, if the customer currently has a three-year license expiring on December 31, Year 7, and exercises its perpetual conversion option on June 30, Year 7, the entity cannot recognize revenue from the exercise of that option before January 1, Year 8.

We believe that this is consistent with the guidance in Topic 606 that if the customer exercises an option to renew a term license, the entity cannot recognize revenue from that renewal until the beginning of the renewal period (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*). The equivalent notion for the exercise of a perpetual conversion option is to recognize that revenue no earlier than after the end of the current term license period when, in effect, the perpetual renewal commences.

Consistent with any other software license, the entity will also need to consider the other guidance in Topic 606 when determining the point in time to recognize the perpetual license – e.g. whether the entity has to provide another copy of the software because the copy of the software delivered for the term license contains a self-destruct or similar mechanism to allow the entity to control the usage of its software. However, we expect that typically the commencement of the perpetual license period will be the 'limiting factor' that will trigger revenue recognition. [606-10-55-58B – 55-58C]

Comparison to legacy US GAAP

Legacy US GAAP is different from the accounting under Topic 606 in two respects.

- Legacy US GAAP concluded that the perpetual conversion option was not an additional element of the arrangement, even if it was being offered at a significant and incremental discount. Therefore, there are perpetual conversion options that may be accounted for as performance obligations under Topic 606 (i.e. if they provide the customer with a material right) that are not accounted for as additional arrangement elements under legacy US GAAP.
- Neither Topic 606 nor legacy US GAAP would permit recognition of any fee for the perpetual license to be recognized before any additional (or new) copy of the software that is necessary to extend the term license perpetually is provided. However, legacy US GAAP recognized the option fee when that software was delivered (or at the option exercise date if no additional software delivery was required). This is likely earlier than when Topic 606 will permit recognition, which is not until after the then-current term license expires.

Question C450

Does a discount need to be significant in addition to being incremental to the range of discounts typically offered to similar customers for it to represent a material right?

Interpretive response: Yes. The FASB noted that the concept of a significant and incremental discount in legacy US GAAP forms the basis for the principle of a material right that is used to differentiate between an option and a marketing or promotional offer. [ASU 2014-09.BC387]

Therefore, we believe a material right is one that is both:

- significant to the customer; and
- incremental to the range of discounts typically given for those goods or services to that class of customer in the applicable area or market.

Entities will need to exercise judgment to determine when a discount is significant.

Question C460

How does an entity determine if a discount is incremental to discounts offered to a similar class of customers?

Interpretive response: The TRG generally agreed with a framework for how an entity evaluates whether a discount on a customer option is incremental to discounts given for goods or services to that class of customer.

The TRG agreed that the objective of the analysis is to determine whether the pricing offered in the customer option would exist independently from the current purchase. If the pricing is independent, it represents a marketing offer and no material right exists. This analysis entails comparing the discount in the current transaction to discounts provided to similar customers in transactions that were not dependent on prior purchases – i.e. discounts not offered through options embedded in similar contracts with other customers. The fact that discounts given to similar customers in stand-alone transactions are similar to the discount offered in the current contract indicates that the customer could obtain the discount without entering into the current contract.

In contrast, the TRG generally agreed it would not be appropriate to compare discounts offered through options embedded in similar contracts with other customers. This comparison would not be relevant because it would not be possible to discern whether the discount provided to the other customer was independent of the current purchase. [TRG Agenda Paper No. 54]

Question C470

Is the evaluation of whether a customer option is a material right only quantitative in nature?

Interpretive response: No. The TRG generally agreed that the assessment of whether an option is a material right is both quantitative and qualitative in nature. TRG members that supported this view believe that considering qualitative factors is consistent with the notion that the existence of implied performance obligations depends on whether a transaction creates reasonable expectations of the customer. Therefore, a material right may exist even if it is not quantitatively material. [TRG Agenda Paper No. 6]

Qualitative factors are particularly important when evaluating the expectations of the customer. Examples of qualitative factors include, but are not limited to:

- availability and pricing of service alternatives;
- average customer life;
- whether a fee incents a customer to remain after the stated contract term ends; and
- whether the right accumulates.

Question C480

How does an entity determine whether a prospective discount based on a customer completing a specified volume of optional purchases is a material right?

Interpretive response: Prospective volume discounts (or rebates) that are earned once a customer has completed a specified volume of optional purchases are evaluated for the presence of a material right and do not give rise to variable consideration. For example, an entity might provide a customer with the option to purchase software at $10 per seat license in the first year of an agreement; but if the entity purchases at least 1,000 licenses, the price in the second year decreases to $8. The purchases in the first year accumulate to give the entity a right to make discounted purchases in the second year.

These prospective volume discounts (or rebates) provide the customer an option to purchase additional goods at a discount. To evaluate if an option represents a material right, the TRG agreed that an entity evaluates whether a similar class of customer could receive the discount independent of a contract with the entity (see Question C460). [TRG Agenda Paper No. 54]

To make that assessment, the entity looks at the range of prices in contracts with customers that purchase similar volumes without a volume-based discount provision and compares those prices against the discounts offered in the current contract. The entity does not compare discounts given to other customers under a similar volume-based discount provision.

However, if there is an accumulating feature, it is a strong indicator of a material right. [TRG Agenda Paper No. 6]

Significant judgment will be required to determine whether discounts provided to customers convey a material right. There are many variations of contracts and variations in facts and circumstances that can affect the conclusion in each fact pattern. Entities should thoroughly evaluate their specific facts and circumstances.

Question C490

Does an option to purchase goods or services for less than stand-alone selling price without any other purchases represent a material right?

Interpretive response: An entity may enter into an agreement that does not obligate the customer to make any purchases but provides it with the right to purchase the goods or services at a discounted price when it submits a purchase order or statement of work. However, discounted prices on their own does not necessarily mean that there is a material right. Similar to any other customer option, entities need to determine if the discount is independent from other purchases. If the discount in a future purchase order is independent from a current contract, then a material right likely does not exist.

The TRG agreed with an example where the entity entered into a new agreement with a customer at significantly discounted prices. In that example, the customer did not pay for the option as it received the discounted prices without making a purchase and each subsequent purchase did not affect the pricing in future contracts. As a result, the TRG concluded that there was no material right. [TRG Agenda Paper No. 54]

In contrast, if the right to the discount accumulates based on additional purchases, there may be a material right. See Example C490.1.

Example C490.1

Discounted pricing not a material right

Software entity offered to supply software licenses at a rate of $100 per seat license for two years, which is below its stand-alone selling price of $200 per seat.

As a result of this offer, Customer and Software entity enter into an MSA. The MSA does not specify a set quantity of software to be purchased but does set the price per seat. As such, each time Customer and Software entity enter into a specific purchase order (contract), it is priced using the price set out in the MSA.

Although Software entity agrees to charge Customer a rate that is less than what it would typically charge a similar customer, this arrangement does not include a material right. This is because the rate per seat that Software entity offers in each purchase order exists independently – the rate Software entity would charge for the second purchase order would be the same regardless of whether the first purchase order was placed.

The objective of the analysis is to determine whether the customer option would exist independently of current purchases. In this example, the pricing set in the MSA is independent of any past purchases – e.g. the terms were negotiated separately. Moreover, the pricing provided to similar customers would not be relevant because the discount already exists outside of an existing contract – i.e. the subsequent purchase orders.

Similarly, when Customer submitted its first purchase order, no material right was present in that contract. That is because Customer already had the right to the future discounts, so those rights existed independently from that purchase order. This is different from discounts earned after the customer completes a certain number of purchases, because in those scenarios the discount would not be available until the customer completes the other purchases. [TRG Agenda Paper No. 54]

D. Step 3: Determine the transaction price

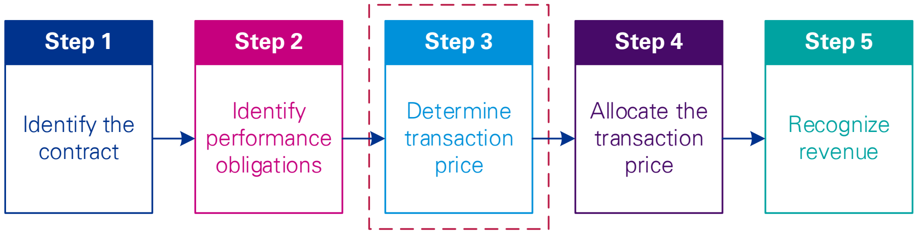
Questions and Examples

Item significantly updated in this edition: #

The existence of a significant financing component in the contract

Noncash consideration

Consideration payable to a customer



This chapter is organized into five sections:

— Transaction price
— Variable consideration
— The existence of a significant financing component in the contract
— Noncash consideration
— Consideration payable to a customer

Transaction price

Excerpt from ASC 606-10

32-1 When (or as) a performance obligation is satisfied, an entity shall recognize as revenue the amount of the transaction price (which excludes estimates of variable consideration that are constrained in accordance with paragraphs 606-10-32-11 through 32-13) that is allocated to that performance obligation.

> Determining the Transaction Price

32-2 An entity shall consider the terms of the contract and its customary business practices to 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, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

32-2A An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process shall be excluded from the scope of the election. An entity that makes this election shall exclude from the transaction price all taxes in the scope of the election and shall comply with the applicable accounting policy guidance, including the disclosure requirements in paragraphs 235-10-50-1 through 50-6.

32-3 The nature, timing, and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity shall consider the effects of all of the following:

a. Variable consideration (see paragraphs 606-10-32-5 through 32-10 and 606-10-32-14)
b. Constraining estimates of variable consideration (see paragraphs 606-10-32-11 through 32-13)
c. The existence of a significant financing component in the contract (see paragraphs 606-10-32-15 through 32-20)
d. Noncash consideration (see paragraphs 606-10-32-21 through 32-24)
e. Consideration payable to a customer (see paragraphs 606-10-32-25 through 32-27).

32-4 For the purpose of determining the transaction price, an entity shall 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 transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services, excluding amounts collected on behalf of third parties. To determine the transaction price, an entity considers the terms of the contract; its customary business practices; and the effects of variable consideration, the constraint on variable consideration, the time value of money, noncash consideration, and consideration payable to the customer.

Transaction price

Variable consideration (and the constraint)

An entity estimates the amount of variable consideration to which it expects to be entitled, giving consideration to the risk of revenue reversal in making the estimate

Significant financing component

For contracts with a significant financing component, an entity adjusts the promised amount of consideration to reflect the time value of money

Noncash consideration

Noncash consideration is measured at fair value, if that can be reasonably estimated; if not, an entity uses the stand-alone selling price of the good or service that was promised in exchange for noncash consideration

Consideration payable to a customer

An entity needs to determine whether consideration payable to a customer represents a reduction of the transaction price, a payment for a distinct good or service, or a combination of the two

The transaction price does not include the effects of a customer's credit risk, except for contracts that contain a significant financing component (whereby the discount rate is credit-adjusted). Rather, credit risk affects whether a contract with a customer exists.

In general, the transaction price includes an entity's estimate of variable consideration. However, an entity will generally not be required to make such an estimate for either:

— variable consideration arising from sales- or usage-based royalties promised in exchange for licenses of intellectual property – see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*; or
— variable consideration that will be recognized in the period in which it is earned based on the variable consideration allocation guidance in

paragraph 606-10-32-40 – See *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*.

When determining the transaction price, an entity assumes that the goods or services will be transferred to the customer based on the terms of the existing contract and does not take into consideration the possibility of a contract being canceled, renewed or modified.

The transaction price includes only amounts (including variable consideration, subject to the constraint on variable consideration) to which the entity has rights under the present contract. For example, the transaction price does not include estimates of consideration from (a) the future exercise of options for additional goods or services or (b) future change orders until the customer exercises its option or approves a change order because the entity does not have a present right to that consideration. [ASU 2014-09.BC186]

The transaction price does not include amounts collected on behalf of third parties (e.g. sales taxes collected by the entity for which it is not the primary obligor to the taxing authority or sales taxes when the entity has elected the US GAAP practical expedient to report sales taxes on a net basis – see the following paragraph), or payments the entity collects for goods or services provided to the customer by third parties when the entity is acting as an agent with respect to those goods or services. Judgment will be required in some cases to determine whether a payment from a customer is an amount collected on behalf of a third party or an element of the transaction price.

The FASB recognized the challenge this judgment can present with respect to some forms of taxes. Consequently, Topic 606 permits entities to make an accounting policy election to exclude all sales taxes and other similar taxes (sales, use, value added and some excise taxes that are imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer) from the measurement of the transaction price. That is, it permits the entity to present all collections from customers for these taxes on a net basis, rather than having to assess whether the entity is acting as an agent with respect to these taxes in each jurisdiction.

Question D10

Should an entity present out-of-pocket costs and related customer reimbursements on a gross basis (i.e. the customer reimbursement as additional transaction price and the out-of-pocket costs as costs of revenue or operating expenses) or a net basis?

Interpretive response: It depends on whether the out-of-pocket costs are the entity's costs (i.e. because it is receiving the good or service from the third party), or the customer's costs (i.e. because the customer is the party receiving the good or service from the third party) for which the entity is merely collecting payment in its role as an agent to the customer or the third party.

Entities performing services for customers (including services in which the entity's role is that of an agent) often incur out-of-pocket costs as part of delivering that service, such as travel and lodging. This is frequently the case when software entities provide professional services (e.g. implementation services and training) in connection with software licensing or software-as-a-service (SaaS) arrangements. In these situations, the entity's engineers or consultants incur such costs in fulfilling the entity's performance obligation to provide the professional services to the customer. Customers frequently agree to reimburse the out-of-pocket costs, often subject to restrictions such as imposing a ceiling on total reimbursements or requiring the entity to follow specific policies (e.g. the customer's expense reimbursement policies) or use the customer's preferred airline or hotel vendor(s).

Regardless of whether a customer imposes restrictions or limits on its reimbursement of out-of-pocket costs, typical out-of-pocket costs (e.g. travel, meals, lodging) and the reimbursements thereof from the customer should be presented on a gross basis. This is because the goods or services (e.g. the transportation, the meal served or lodging provided to the entity's employee) giving rise to the out-of-pocket costs do not transfer a good or service to the customer. Rather, the good or service is used or consumed by the entity in fulfilling its performance obligation to the customer. Therefore, the out-of-pocket cost is the entity's cost rather than the customer's. The costs, while reimbursable, should be accounted for in the same manner as any other fulfillment costs (see *Chapter H – Contract costs*). Meanwhile, the reimbursements are variable consideration, subject to the same accounting guidance as any other variable consideration.

Customer reimbursements of the entity's out-of-pocket costs should be distinguished from situations in which the entity is being reimbursed for 'customer' costs the entity has paid 'on behalf of the customer' to a third party. For example, an agent may, as part of providing a service of arranging for a third party to provide a specified good or service (e.g. SaaS or cloud-based storage), remit payment to the third party (i.e. the principal) for the specified good or service and then obtain reimbursement for that payment from the customer at a later date. In that case, because the payment to the third party is payment for the customer's cost (rather than the entity's cost), the reimbursement is not part of the transaction price of the entity's contract with its customer. Consequently, the customer reimbursement is presented net of the payments made to the third-party principal.

Example D10.1

Reimbursable and pass-through costs (comprehensive example)

ABC Corp. enters into a contract with Customer to provide SaaS and certain implementation services (e.g. some training and basic interfacing). Assume the SaaS and the implementation services are distinct from each other (see Question C280) and both are performance obligations satisfied over time (see Questions F130 and F190). ABC also arranges for a third-party vendor to provide data conversion and migration services to Customer that ABC does not provide to any of its customers. Customer enters into a contract for those data conversion and migration services directly with the third-party service vendor, which designates ABC as an authorized agent of the third-party vendor. ABC does not control the services before they are provided to Customer by the third party and, therefore, is an agent with respect to the services.

Under the terms of the contract between ABC and Customer, Customer will reimburse ABC for any out-of-pocket costs incurred in performing the implementation services (e.g. ABC personnel travel-related costs to Customer's location or the printing and shipping of training-related materials). The contracts, together, stipulate that Customer will remit payment for both the ABC-provided SaaS and the third-party-provided data conversion and migration services to ABC, who will then remit the agreed payment to the third-party vendor net of the commission to which it is entitled under its contract with the third-party vendor (i.e. ABC receives 5% of the contract price between Customer and the third party).

The contract price for the SaaS and the implementation services is $100,000; the contract price for the third-party services is $10,000 (5% of which is $500). The stand-alone selling prices for the SaaS and the implementation services are $85,000 and $25,000, respectively.

Third-party services

The payment made to ABC for the third-party data conversion and migration services is not part of the transaction price of the contract between ABC and Customer. Consistent with paragraph 606-10-32-2, that payment is an amount collected on behalf of the third-party service vendor for services the third party is providing (as a principal) to Customer. ABC further concludes that, in this case, the $500 it retains from the payment as an agency fee is also not part of the transaction price of its contract with Customer. In this case, because ABC has a partnership agreement with the third-party partner, it concludes that the third party is its customer for the agency service (i.e. it is providing the agency service to the third party, not to Customer). Consequently, the $500 agency fee is not a part of its contract with Customer, but rather part of a separate contract with the third-party partner that is unrelated to Customer. ABC will recognize the $500 agency fee when it has satisfied its performance obligation to arrange for the third-party partner to provide the data conversion and migration services.

Out-of-pocket costs

The out-of-pocket costs (e.g. for travel and printed training materials) are fulfillment costs of ABC to satisfy its performance obligation to provide implementation services to Customer. Because the out-of-pocket costs are ABC's fulfillment costs incurred to satisfy its services performance obligation to Customer, rather than Customer costs for third-party services being provided to Customer, those costs are presented on a gross basis separate from the related customer reimbursements.

The out-of-pocket fulfillment costs are expensed as incurred, consistent with any other fulfillment costs ABC incurs related to the implementation services, because when incurred they relate to a partially satisfied implementation services performance obligation (see Question H230).

The reimbursements of the out-of-pocket costs represent variable consideration such that the transaction price for the contract is variable. Based on its relevant experience, ABC estimates, in accordance with paragraphs 606-10-32-5 through 32-9, that its out-of-pocket costs will be $2,000. ABC further concludes that it does not need to 'constrain' that estimate of variable consideration. This is because both (1) ABC has significant relevant experience that is driving its estimate of the out-of-pocket costs and (2) any potential revenue reversal against cumulative revenue recognized under the contract to that point that might result is not significant given that the out-of-pocket cost amount will be known relatively early in the performance of the implementation services (i.e. ABC's travel costs to get to Customer's site or to print training-related materials will be known before the services are performed) such that little revenue will likely have been recognized under the contract at the point any substantive 'true-up' of the out-of-pocket cost estimate is required.

Next, ABC concludes that the variable consideration – which only results from the out-of-pocket costs reimbursement – should be allocated entirely to the implementation services performance obligation. In accordance with paragraph 606-10-32-40 (see *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*), ABC concludes that (1) the out-of-pocket costs to be incurred relate solely to ABC's efforts to fulfill the implementation services and (2) allocating this relatively minor amount entirely to the implementation services is consistent with the overall transaction price allocation objective in paragraph 606-10-32-28. ABC reaches the latter conclusion on the basis that the allocation of the $2,000 entirely to the implementation services results in a relative stand-alone selling price that is consistent with the stand-alone selling price for the services and because an entity providing the services separately (e.g. a consulting services provider not providing the SaaS) would typically price those services either to include a reimbursement provision similar to the one in the ABC/Customer contract or include a fixed amount intended to recover similar out-of-pocket costs.

Consequently, ABC's transaction price allocation for the contract with Customer is as follows.

	Stand-alone selling price (SSP)	**% of SSP**	**Relative SSP**	**Variable consideration**	**Total allocated transaction price**
SaaS	$85,000	77.3%	$77,273	$ 0	$77,273
Implementation	25,000	22.7%	22,727	2,000	24,727
	$110,000	100.0%	$100,000	$2,000	$102,000

Assuming the SaaS, like the implementation services, is a performance obligation satisfied over time, ABC will recognize the transaction price allocated to each of the two performance obligations as the SaaS and the implementation services are provided using an appropriate measure of progress for each (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation* for further discussion about whether a SaaS performance obligation is satisfied over time and appropriate measures of progress). Because Topic 606 requires entities to use a *single* measure of progress toward satisfaction of a performance obligation, it would not be appropriate to apply one measure of progress to the $22,727 and another to the $2,000 in anticipated customer out-of-pocket cost reimbursements. Therefore, it would only be acceptable to recognize the reimbursements when the costs are incurred if (1) ABC were using a cost-to-cost measure of progress for the implementation services performance obligation as a whole and (2) the incurrence of the out-of-pocket costs represents progress towards satisfaction of the performance obligation (see paragraph 606-10-55-21).

Comparison to legacy US GAAP

Under legacy US GAAP (paragraph 605-45-45-23), reimbursements of out-of-pocket expenses were required to be presented as revenue, gross from the associated out-of-pocket costs, in all circumstances. In contrast, Topic 606 does not include an explicit 'rule' in this regard; rather an entity considers whether it is a principal or an agent with respect to the cost (i.e. whether the cost for which it will receive payment from the customer is *its* cost or the customer's cost). However, while the guidance in Topic 606 does not have the same explicit rule, and relies instead upon a principal versus agent concept, we do not believe the changes to the guidance will result in any significant changes from current practice with respect to how entities present most out-of-pocket costs, including customer reimbursements thereof.

However, the timing of revenue recognition for customer reimbursements may be earlier or later than under legacy US GAAP because of the guidance in Topic 606 about estimating variable consideration – i.e. under Topic 606, the estimated customer reimbursements will be recognized, consistent with the entity's measure of progress for the related performance obligation, which could be earlier or later than when the costs are incurred and when such amounts were recognized under legacy US GAAP.

Question D15

What types of taxes or fees qualify for the policy election to be excluded from the transaction price?

Interpretive response: Topic 606 permits an entity to elect to present all collections from customers for certain taxes on a net basis, rather than having to assess whether the entity is acting as principal or agent in each tax jurisdiction. [606-10-32-2A]

Taxes qualify for the policy election if they are collected from customers and remitted to governmental authorities that imposed the tax both on and concurrent with a specific revenue-producing transaction between a seller and a customer. These taxes may include, but are not limited to, sales, use, value-added and some excise taxes as well as other taxes referred to as 'fees'. However, the policy election does not apply to tax schemes that are based on gross receipts and taxes that are imposed during the inventory procurement process. [606-10-32-2A]

Collecting the tax from the customer does not automatically designate the tax as specific to revenue-producing activities. An entity evaluates the nature of the tax to determine if the tax is imposed on and concurrent with specific revenue-producing transactions or if the tax is more akin to a gross receipts tax.

We believe the following are indicators that the tax is imposed on individual transactions and would qualify for the Topic 606 policy election to be excluded from the transaction price and presented on a net basis.

— The tax is imposed on individual sales transactions as identified in a law or regulation.
— The individual sales transaction is what creates the obligation on the entity to remit fees or taxes to the governmental authority.
— The tax is applied to specific types of transactions, on certain revenue streams or for certain products and services.
— Transactions or revenues with specified entities (e.g. not-for-profit entities) may be exempt.

The following are indicators that the tax is a gross receipts tax, and therefore not eligible for the Topic 606 policy election.

— The tax is imposed on an accumulation of earnings or applied based on graduated rates.
— The tax allows specified deductions (other than specific revenue-related adjustments – e.g. billing credits, sales returns, uncollected accounts), credits for other taxes paid or apportionment factors.
— There are minimum thresholds to be exceeded before there is an obligation to file a return or remit taxes or fees.
— It includes types of income that are not the result of transactions with customers (e.g. nonoperating income).
— It interacts with other tax systems (e.g. the tax is the lesser or greater of a sales-based calculation or an income-based calculation).

None of the above factors is presumptive or determinative. Certain taxes include characteristics of both sales taxes and gross receipts taxes and may require significant judgment to determine their eligibility for the policy election. All relevant facts and circumstances should be considered.

Example D15.1
Taxes collected from customer – gross reporting

ABC Corp. provides professional services to companies on cloud platforms. A tax is implemented on companies who provide professional services on a digital platform with annual platform revenues in excess of $500 million. The tax is 5% on amounts in excess of $500 million and is due in February based on the taxable revenue collected in the previous calendar year. ABC passes on this tax to its customers and collects the tax each time the customer is invoiced.

ABC must evaluate whether the tax due is specific to revenue-producing transactions or is more akin to a gross receipts tax on the business. This tax is based on revenue generated over a certain dollar threshold and is taxed on revenue for professional services provided by companies on a digital platform; therefore, it is more in line with a gross receipts tax rather than a tax imposed on and concurrent with specific revenue-producing transaction. As a result, ABC concludes that the tax is a gross receipts tax that does not qualify for the policy election to net costs against revenue.

Question D20

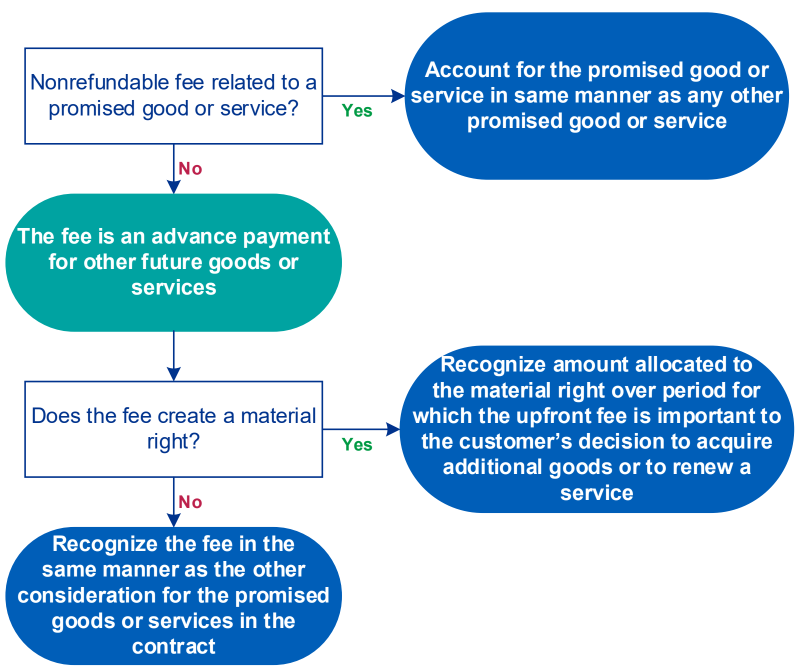
Are nonrefundable upfront fees included in the transaction price for a contract with a customer?

Interpretive response: Yes. Some contracts include nonrefundable upfront fees that are paid at or near contract inception – e.g. joining fees for health club membership, activation fees for telecommunication contracts and set-up fees for SaaS arrangements or hosting services.

Often a nonrefundable upfront fee relates to an activity that does not transfer a good or service to the customer – e.g. set-up activities in a SaaS arrangement (see Question C220) or an 'administrative task' such as setting up the customer's billing account. In other cases an upfront fee will relate to the transfer of a good or service (e.g. a software license that is transferred at or near contract inception or implementation services provided by the entity in a software licensing or a SaaS arrangement).

Regardless of whether the nonrefundable upfront fee is identified in the contract as relating to a specific good or service to be provided to the customer, it is, nevertheless, a part of the transaction price of the contract that will be allocated to the contract's performance obligations. As discussed in Question C410, the inclusion of a nonrefundable upfront fee in a contract may indicate a 'material right' exists, which is an additional performance obligation of the contract that will receive an allocation of the transaction price. *Chapter E – Step 4: Allocate the transaction price to performance obligations in the contract* discusses the key considerations relative to allocating a transaction price that includes a nonrefundable upfront fee.

The following figure summarizes the requirements in accounting for a nonrefundable upfront fee.



Example D20.1
Nonrefundable upfront fees for set-up activities

ABC Corp. is a SaaS provider of digital advertising services. ABC enters into a statement of work (SOW) with Customer whereby Customer pays ABC a $10 million nonrefundable fee for activities to substantially increase Customer's ability to use ABC's SaaS platform. The activities relate to ABC expanding capacity at its own data center and increasing its employee headcount. The contract does not contain a lease.

At the same time, ABC and Customer enter into a master service agreement (MSA) that outlines the terms for future arrangements into which ABC and Customer may enter, including required service levels. ABC would not be able to serve Customer at the desired scale set forth in the MSA and Customer would not contract with ABC for the data center build out if Customer was not also contracting for the ongoing services in the MSA. The MSA is not a contract under Topic 606 because it does not create enforceable rights and obligations until a subsequent purchase order is consummated (see Question B30). However, the SOW and MSA are evaluated together because they are entered into at or near the same time and negotiated with a single commercial objective; see *Chapter B – Step 1: Identify the contract with customer* for considerations on when to combine contracts.

The activities in the SOW represent tasks required to fulfill future contracts with Customer under the MSA. Therefore, ABC considers whether the activities in the SOW transfer goods or services to the customer or are set-up activities. ABC concludes that the activities are set-up activities because they relate to its own assets (build out of the data center) and operations (hiring of employees) and therefore those items are not transferred to Customer. Further, because they relate to ABC's own assets, the activities do not provide *incremental* benefit to Customer beyond any future SaaS services under the MSA. As a result, ABC also concludes that the fees are in effect nonrefundable fees associated with future contracts under the MSA.

Because the MSA only represents options for additional services, ABC concludes that the nonrefundable upfront fees and optional purchases in the MSA convey a 'material right' consistent with Question C410. ABC will allocate the upfront fee to the customer options to which it relates (see Question E390 and Example E390.1).

Comparison to legacy US GAAP

Concluding whether a nonrefundable upfront fee represents a payment for a promised good or service under Topic 606 may involve an analysis similar to that undertaken for legacy US GAAP to determine whether the upfront fee is payment for delivery of a good or a service that represents the culmination of a separate earnings process. When performing the analysis under Topic 606, an entity considers the guidance in Step 2 of the model, which is not necessarily the same as legacy US GAAP.

Under the SEC guidance (SAB Topic 13) applicable to legacy US GAAP, an upfront fee that is not a payment for delivery of a good or a service that represents the culmination of a separate earnings process is deferred and recognized over the expected period of performance, which can extend beyond the initial contract period. In our experience, this has often resulted in an entity recognizing nonrefundable upfront fees over the average customer relationship period.

Under Topic 606, an entity assesses the upfront fee to determine whether it provides the customer with a material right – and, if so, for how long. This means that an entity no longer defaults to an average customer relationship period, which may be driven by factors other than the payment of an upfront fee. These factors may include the availability of viable alternatives, the entity's customer service, the inconvenience of changing service providers, or the quality of the product or service offering.

Variable consideration

Excerpt from ASC 606-10

>> Variable Consideration

32-5 If the consideration promised in a **contract** includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a **customer**.

32-6 An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration also can 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 either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

32-7 The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

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.
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.

32-8 An entity shall estimate an amount of variable consideration 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—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—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).

32-9 An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current, and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

>>> Refund Liabilities

32-10 An entity shall recognize a refund liability if the entity 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**) shall be updated at the end of each reporting period for changes in circumstances. To account for a refund liability relating to a sale with a right of return, an entity shall apply the guidance in paragraphs 606-10-55-22 through 55-29.

Types of variable consideration

The amount of consideration to which an entity expects to be entitled can vary due to the existence of one or more of the following:

- discounts
- rebates
- refunds
- credits
- price concessions
- incentives
- performance bonuses or penalties.

The promised consideration also can vary if the entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event, even if the contract price appears to be fixed. For example, the amount of consideration promised in a fixed-price SaaS contract would be variable if the contract includes service level guarantees that could result in the entity providing credits or refunds to the customer as a penalty for not meeting the specified service levels (see Question D170).

Variability in the contract consideration may be explicit or implicit, arising from customary business practices, published policies or specific statements, or any other facts and circumstances that would create a valid expectation by the customer. For example, explicit price concessions may be granted to enhance a customer relationship to encourage future sales to that customer or as part of an overall strategy to develop the customer relationship, while implicit price concessions occur when the entity's customary business practices, published policies or specific statements, or other relevant facts and circumstances indicate that the entity may accept a lower price than that stated in the contract.

Accounting for variable consideration

An entity estimates an amount of variable consideration by using one of the following methods, applied consistently to similar contracts, depending on which method the entity expects to better predict the amount of consideration to which the entity will be entitled (i.e. it is not a 'free choice').

Expected value	The entity considers the probability-weighted amounts for a range of possible consideration outcomes. This may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics and may be more appropriate when an entity has a large number of possible outcomes.
Most likely amount	The entity considers the single most likely amount from a range of possible consideration outcomes. This may be an appropriate estimate of the amount of variable consideration if the contract has only two (or perhaps a few) possible outcomes (e.g. an entity either will achieve a performance bonus or not).

In general, it is important for an entity to have a sufficiently large number of similar transactions to conclude that the expected value method is more appropriate than the most likely amount method. Judgment is required to determine whether:

- the transactions are sufficiently similar;
- the transactions from which the expected value is derived are expected to be consistent with the current contract; and
- the volume of similar contracts is sufficient to develop an expected value.

An entity considers all information available when making its estimate of variable consideration and updates the estimate at each reporting date.

An entity recognizes a refund liability for consideration received or receivable if it expects to refund some or all of the consideration to the customer. Topic 606 applies the mechanics of estimating variable consideration in a variety of scenarios, some of which include fixed consideration – e.g. sales with a right of return and customers' unexercised rights (breakage).

Question D30

Can management simply use its 'best estimate' when estimating variable consideration?

Interpretive response: No. The Boards considered, and ultimately rejected allowing a method of applying management's best estimate without an appropriate framework that would ensure rigor in the process of estimation. The Boards concluded that, without such a framework, the measurement of revenue might not be understandable to users and might lack comparability between entities. As a result, the Boards developed a framework requiring that an entity use either the expected value method or the most likely amount method, depending on the specific facts and circumstances, for estimating variable consideration outlined. [ASU 2014-09.BC198]

Question D40

What should a software entity consider in deciding whether it has a sufficient number of similar contracts to use the expected value method for estimating variable consideration?

Interpretive response: In some cases, a software entity's ability to use the expected value method will be clear. For example, SaaS providers that have substantially similar contracts with all customers accessing its hosted software in a multi-tenant environment will generally have a sufficient portfolio of data from which to use an expected value method to estimating variable consideration resulting from items such as service level guarantees. Another example could be a software licensing entity that, as its standard practice, enters into three-year licenses for the same products and services with all (or most) of its customers.

However, an entity's software contracts are also often quite customer-specific. For example, for some software entities, customers rarely obtain licenses to the same mix of software products, or even similar product mixes may include very different licenses (e.g. perpetual versus term licenses or licenses that include different restrictions on use). For other entities, their customers acquire different software-related services – e.g. one customer may request customization, while another does not but contracts for a more extensive suite of implementation services, and a third requests that the entity host the licensed software.

Use of the expected value method does not necessarily require homogenous customer contracts; rather, it merely requires that there be common characteristics *relevant to the estimation of the variable consideration*. For example, even if a software entity never licenses the same mix of software products to any two customers or has a wide variety of license terms, its implementation or hosting services provided for its different software products and licenses may be substantially similar such that it can use the expected value method to estimate the likelihood of earning performance bonuses or incurring penalties related to those services. Similarly, even if the entity's customers enter into widely varied arrangements for different mixes of software licenses and services, the entity's hosting services may be generally consistent such that, even though the software being hosted may differ substantially between customers, the portfolio of customer contracts that include hosting services provide relevant, predictive evidence about whether the entity will be required to provide service level credits or refunds to customers.

There are various attributes of a software entity's customer contract portfolio that may provide similarities relevant to different types of variable consideration. Some examples of attributes around which an entity may be able to develop a portfolio of data (even if the contracts are not substantially similar overall), and relevance to variable consideration, include (not exhaustive):

— **Perpetual versus term licensing** – it may be that customers under term licenses are more likely to be granted concessions (which are variable consideration – see Question D130) to induce renewal than customers with perpetual licenses.

— **Type or class of customer** – it may be that larger customers are granted concessions, but smaller customers are not; that larger customers have more stringent performance bonus/penalty provisions in their contracts than smaller customers; or that reseller customers (as compared to end-user customers) are more likely to return software licenses.

— **Payment terms** – it may be that customers with extended payment terms are more likely to be granted concessions (see Question D150).

— **Types of products or services** – it may be that the software entity's performance record on implementing or customizing software successfully within a predetermined timeframe differs depending on the nature of those services or the software products being implemented or customized.

Question D50

When estimating the expected value or when applying the most likely amount method, does an entity need to consider all possible outcomes?

Interpretive response: No. Although in theory, an entity using the most likely amount method considers all the possible outcomes to identify the most likely one, in practice, there is no need to quantify the less probable outcomes. [ASU 2014-09.BC201]

Similarly, in practice, estimating the expected value using a probability-weighted method does not require an entity to explicitly quantify probabilities for all possible outcomes using complex models and techniques. Using a smaller number of discrete outcomes might provide a reasonable estimate of the distribution of possible outcomes.

Regardless of the method used, an entity should consider all the information (historical, current and forecasted) that is reasonably available when making its estimate.

Question D60

Is an entity required to use a single method to estimate the transaction price consistently for all variable payment terms in the same contract?

Interpretive response: No. Using a different method for different payment streams within the same contract is permissible, provided the methods are consistently applied for the duration of the contract. For example, it would be permissible to apply the most likely amount method to a performance bonus related to implementation services provided under the contract, while using the expected value method to estimate the variable consideration for a right of return on the software licenses or in estimating service level credits (see Question D170) in a SaaS arrangement.

Question D70

Once an entity has elected to apply either the 'most likely amount' method or the 'expected value' method for estimating a variable consideration element, is the selected method applied consistently throughout the course of the contract?

Interpretive response: Yes. Paragraph 606-10-32-9 states that "when estimating the transaction price, an entity shall apply one method consistently throughout the contract." Therefore, the method selected for a variable consideration element (e.g. in estimating the performance bonus or the right of return used as an example in Question D60) is consistently applied to that individual element for the duration of the contract.

Question D80

Is an entity required to apply the same method of estimating variable consideration to all similar variable fee terms within a portfolio of contracts with customers?

Interpretive response: We would generally expect the same method of estimating a variable transaction price to be applied to similar variable fee terms across an entity's portfolio of contracts absent a change in circumstances or business practices. However, the objective for each contract is to develop an estimate of the amount that is most predictive of amount to which the entity will be entitled to and therefore there may be exceptions due to the specific circumstances of a contract with a particular customer.

Question D90

Is using relevant information from a portfolio of similar contracts to estimate variable consideration the same as applying the portfolio approach practical expedient?

Interpretive response: No. This question was discussed by the TRG at the March 2015 meeting. The TRG members agreed with the views of the FASB and IASB staffs that using a portfolio of data to develop estimates required to apply the revenue model in Topic 606, including estimates of variable consideration using the expected value method, is not the same as applying the portfolio approach practical expedient. This means that there is no requirement for entities using a portfolio of data of similar contracts to apply the expected value method to evaluate whether the results of using that portfolio of data to develop the estimate would differ materially from developing an estimate based on contract-specific data. Question D110 highlights that an entity's estimate resulting from an expected-value method estimate does not have to equal a possible outcome of the contract.

Question D100

Does denomination in a currency other than the entity's functional currency mean the contract includes variable consideration?

Interpretive response: No. Entities may enter into contracts denominated in a foreign currency. Although the contract may state a fixed price in that foreign currency, the amount received by the entity in its functional currency will vary based on the changes in the exchange rate in effect between the date the contract is entered into and when the payment is received.

Foreign currency is not 'noncash consideration'; it is still 'cash'. Paragraph 830-230-45-1 supports this in stating that the statement of cash flows "reports the effect of exchange rate changes on cash balances held in foreign currencies as a separate part of the reconciliation of the change in cash and cash equivalents during the period." The measurement of that foreign-denominated cash quantifies the amount to record for accounting purposes, as described in paragraph 830-10-55-1.

Therefore, contracts denominated in a currency other than the entity's functional currency should be measured into the entity's functional currency using the foreign exchange rate in effect on the date of either transfer of the goods or services or payment in advance by the customer, whichever is first (see Topic 830, *Foreign Currency Matters*). Changes in the foreign exchange rate between contract inception and the date of either transfer of the goods or services or payment in advance by the customer, whichever is first, would therefore affect the amount of revenue recognized.

Constraint on variable consideration

Excerpt from ASC 606-10

>>> Constraining Estimates of Variable Consideration

32-11 An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 only to the extent that it is **probable** that a significant reversal in the amount of cumulative **revenue** recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

32-12 In assessing whether it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.
b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

The contract has a large number and broad range of possible consideration amounts.

32-13 An entity shall apply paragraph 606-10-55-65 to account for consideration in the form of a sales-based or usage-based royalty that is promised in exchange for a license of intellectual property.

>>> Example 22—Right of Return

55-202 An entity enters into 100 contracts with customers. Each contract includes the sale of 1 product for $100 (100 total products × $100 = $10,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is $60.

55-203 The entity applies the guidance in this Topic to the portfolio of 100 contracts because it reasonably expects that, in accordance with paragraph 606-10-10-4, the effects on the financial statements from applying this guidance to the portfolio would not differ materially from applying the guidance to the individual contracts within the portfolio.

55-204 Because the contract allows a customer to return the products, the consideration received from the customer is variable. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 97 products will not be returned.

55-205 The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of $9,700 ($100 × 97 products not expected to be returned) can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (that is, the 30-day return period). Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $9,700) will not occur as the uncertainty is resolved (that is, over the return period).

55-206 The entity estimates that the costs of recovering the products will be immaterial and expects that the returned products can be resold at a profit.

55-207 Upon transfer of control of the 100 products, the entity does not recognize revenue for the 3 products that it expects to be returned. Consequently, in accordance with paragraphs 606-10-32-10 and 606-10-55-23, the entity recognizes the following:

Cash	$10,000 ($100 × 100 products transferred)
Revenue	$9,700 ($100 × 97 products not expected to be returned)
Refund liabilities	$300 ($100 refund × 3 products expected to be returned)
Cost of sale	$5,820 ($60 × 97 products not expected to returned)
Asset	$180 ($60 × 3 products for its right to recover products form customers on settling the refund liability)
Inventory	$6,000 ($60 × 100 products)

>>> Example 23—Price Concessions

55-208 An entity enters into a contract with a customer, a distributor, on December 1, 20X7. The entity transfers 1,000 products at contract inception for a price stated in the contract of $100 per product (total consideration is $100,000). Payment from the customer is due when the customer sells the products to the end customers. The entity's customer generally sells the products within 90 days of obtaining them. Control of the products transfers to the customer on December 1, 20X7.

55-209 On the basis of its past practices and to maintain its relationship with the customer, the entity anticipates granting a price concession to its customer because this will enable the customer to discount the product and thereby move the product through the distribution chain. Consequently, the consideration in the contract is variable.

>>>> Case A—Estimate of Variable Consideration Is Not Constrained

55-210 The entity has significant experience selling this and similar products. The observable data indicate that historically the entity grants a price concession of approximately 20 percent of the sales price for these products. Current market information suggests that a 20 percent reduction in price will be sufficient to move the products through the distribution chain. The entity has not granted a price concession significantly greater than 20 percent in many years.

55-211 To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates the transaction price to be $80,000 ($80 × 1,000 products).

55-212 The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of $80,000 can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and determines that it has significant previous experience with this product and current market information that supports its estimate. In addition, despite some uncertainty resulting from factors outside its influence, based on its current market estimates, the entity expects the price to be resolved within a short time frame. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $80,000) will not occur when the uncertainty is resolved (that is, when the total amount of price concessions is determined). Consequently, the entity recognizes $80,000 as revenue when the products are transferred on December 1, 20X7.

>>>> Case B—Estimate of Variable Consideration Is Constrained

55-213 The entity has experience selling similar products. However, the entity's products have a high risk of obsolescence, and the entity is experiencing high volatility in the pricing of its products. The observable data indicate that historically the entity grants a broad range of price concessions ranging from 20 to 60 percent of the sales price for similar products. Current market information also suggests that a 15 to 50 percent reduction in price may be necessary to move the products through the distribution chain.

55-214 To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that a discount of 40 percent will be provided and, therefore, the estimate of the variable consideration is $60,000 ($60 × 1,000 products).

55-215 The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether some or all of the estimated amount of variable consideration of $60,000 can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and observes that the amount of consideration is highly susceptible to factors outside the entity's influence (that is, risk of obsolescence) and it is likely that the entity may be required to provide a broad range of price concessions to move the products through the distribution chain. Consequently, the entity cannot include its estimate of $60,000 (that is, a discount of 40 percent) in the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Although the entity's historical price concessions have ranged from 20 to 60 percent, market information currently suggests that a price concession of 15 to 50 percent will be necessary. The entity's actual results have been consistent with then-current market information in previous, similar transactions. Consequently, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur if the entity includes $50,000 in the transaction price ($100 sales price and a 50 percent price concession) and, therefore, recognizes revenue at that amount. Therefore, the entity recognizes revenue of $50,000 when the products are transferred and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved in accordance with paragraph 606-10-32-14.

>>> Example 24—Volume Discount Incentive

55-216 An entity enters into a contract with a customer on January 1, 20X8, to sell Product A for $100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to $90 per unit. Consequently, the consideration in the contract is variable.

55-217 For the first quarter ended March 31, 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

55-218 The entity considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $100 per unit) will not occur when the uncertainty is resolved (that is, when the total amount of purchases is known). Consequently, the entity recognizes revenue of $7,500 (75 units × $100 per unit) for the quarter ended March 31, 20X8.

55-219 In May 20X8, the entity's customer acquires another company and in the second quarter ended June 30, 20X8, the entity sells an additional 500 units of Product A to the customer. In light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and, therefore, it will be required to retrospectively reduce the price per unit to $90.

55-220 Consequently, the entity recognizes revenue of $44,250 for the quarter ended June 30, 20X8. That amount is calculated from $45,000 for the sale of 500 units (500 units × $90 per unit) less the change in transaction price of $750 (75 units × $10 price reduction) for the reduction of revenue relating to units sold for the quarter ended March 31, 20X8 (see paragraphs 606-10-32-42 through 32-43).

>>> Example 25—Management Fees Subject to the Constraint

55-221 On January 1, 20X8, an entity enters into a contract with a client to provide asset management services for five years. The entity receives a 2 percent quarterly management fee based on the client's assets under management at the end of each quarter. In addition, the entity receives a performance-based incentive fee of 20 percent of the fund's return in excess of the return of an observable market index over the 5-year period. Consequently, both the management fee and the performance fee in the contract are variable consideration.

55-222 The entity accounts for the services as a single performance obligation in accordance with paragraph 606-10-25-14(b), because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

55-223 At contract inception, the entity considers the guidance in paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity observes that the promised consideration is dependent on the market and, thus, is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in determining the future performance of the market. Therefore, at contract inception, the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

55-224 At each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price at those dates. This is because there has not been a change in its assessment from contract inception—the variability of the fee based on the market index indicates that the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the incentive fee in the transaction price. At March 31, 20X8, the client's assets under management are $100 million. Therefore, the resulting quarterly management fee and the transaction price is $2 million.

55-225 At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter in accordance with paragraphs 606-10-32-39(b) and 606-10-32-40. This is because the fee relates specifically to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters, and the resulting allocation will be consistent with the allocation objective in paragraph 606-10-32-28. Consequently, the entity recognizes $2 million as revenue for the quarter ended March 31, 20X8.

The objective of the constraint on variable consideration is to reduce the risk that an entity recognizes a significant revenue reversal (a downward adjustment to revenue) from subsequent changes in the estimate of the amount of variable consideration to which the entity is expected to be entitled. As described in the Basis for Conclusions to ASU 2014-09 (BC207), the constraint introduces a downward bias into estimates, requiring entities to exercise prudence before they recognize revenue – i.e. they are required to make a non-neutral estimate. This exception to the revenue recognition model, and to the Boards' respective conceptual frameworks' requirement to make neutral estimates, reflects the particular sensitivity with which revenue reversals are viewed by many users and regulators.

Therefore, in accordance with the objective of the constraint, an entity includes an estimated amount of variable consideration in the transaction price only if it is probable that a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal. A significant revenue reversal would occur if a subsequent change in the estimate of the variable consideration would result in a significant downward adjustment on the amount of cumulative revenue recognized from that contract when the change in estimate occurs. The term 'probable' is used in the same way as it is in Topic 450, *Contingencies* – i.e. "the future event or events are likely to occur." Because probable is not as high of a threshold as, for example, 'virtually certain', even though the intent of the constraint is to prevent significant downward adjustments to previously recognized revenue, such adjustments may occur.

The entity would meet the objective of the constraint if it has sufficient experience or evidence to support that an amount of variable consideration, if included in the transaction price and recognized as revenue, does not risk a significant revenue reversal. Importantly, not having sufficient experience or evidence to support that including the *entire* amount of variable consideration in the transaction price does not have a risk of resulting in a significant revenue reversal does not mean the transaction price should not include some portion of the variable consideration. If an entity expects that including some, but not all, of the estimated amount of variable consideration (i.e. a minimum amount) in the transaction price would not result in a significant revenue reversal, the entity includes that amount (and subsequent changes to that amount) in the estimate of the transaction price. This means that, in many cases, even if there is significant uncertainty about variable consideration, the amount of variable consideration included in the transaction price will be greater than zero.

The entity's assessment of whether its experience or other evidence is sufficient to support its assessment is qualitative and should take into account all the relevant facts and circumstances associated with both:

— the likelihood of a downward adjustment in the estimate of variable consideration (e.g. the risk of such an adjustment arising from an uncertain future event); and

— the magnitude of the reversal if that uncertain event were to occur or fail to occur. An entity assesses the potential magnitude of a significant revenue reversal relative to the cumulative revenue recognized to-date under the contract – i.e. for both variable and fixed consideration, rather than on a reversal of only the variable consideration. See Question D176 on the unit of account for performing this analysis.

Factors that indicate that including an estimate of variable consideration in the transaction price could result in a significant revenue reversal include, but are not limited to, the following.

— The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

— The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

— The entity's experience (or other evidence) with similar types of contracts is limited or that experience (or other evidence) has limited predictive value.

— The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

— The contract has a large number and broad range of possible consideration amounts.

If the risk of a downward adjustment in the estimate of variable consideration is low or the potential magnitude of the revenue reversal that would result from that downward adjustment is minor, then the constraint does not affect the estimated amount of variable consideration.

An entity does *not* consider collectibility of the consideration (i.e. customer credit risk) when evaluating either its estimate of variable consideration or the applicability of the constraint. The effect of credit risk is addressed separately in *Chapter B – Step 1: Identify a contract with a customer*. Step 1 of the Model includes an explicit collectibility threshold as a criterion to conclude that a contract exists within the Topic 606 revenue model.

Reassessment of variable consideration

Excerpt from ASC 606-10

>>> Reassessment of Variable Consideration

32-14 At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity shall account for changes in the transaction price in accordance with paragraphs 606-10-32-42 through 32-45.

An entity's estimate of variable consideration will frequently change after contract inception. For example, uncertainties will be resolved or new information will arise with respect to remaining uncertainties such that the entity must revise its expectations about the amount of variable consideration to which it expects to be entitled. To account for conditions that exist at each reporting date (and changes in conditions during the reporting period), an entity updates its estimates of variable consideration and amounts of that variable consideration that should be constrained throughout the contract.

Question D110

Does the transaction price in a contract with variable consideration have to equal a possible outcome of the contract?

Interpretive response: No. Some variable consideration arrangements have a limited number of possible outcomes. For example, an arrangement under which an entity provides services may include incentives or penalties for good or poor performance that only have a limited number of possible outcomes. Consider a scenario where the entity stands to earn potential bonuses of $300, $200 or $100 if a project is completed before specified dates and penalties of $100, $200 and $300 if the project is completed after specified dates. On-time performance results in the entity earning $500. In this scenario the only possible outcomes for the transaction price are $200, $300, $400, $500, $600, $700 and $800. This is a scenario that may occur in some software or SaaS development projects or large-scale implementation projects.

In scenarios such as this, entities having a sufficient volume of similar arrangements (see Question D40) may determine that the expected value method is the most appropriate method to estimate the variable consideration. At the July 2015 TRG meeting, it was discussed whether the transaction price must equal a possible outcome of the contract – e.g. in the scenario above, must the estimated transaction price be one of those possible outcomes. The FASB and IASB staffs expressed the view, with which most TRG members agreed, that when using the expected value estimation method for variable consideration, the estimated transaction price does not need to be an amount that is a possible outcome for an individual contract – i.e. in the scenario above, the estimated transaction price, before and after consideration of the constraint, can be a number other than those listed. However, because of the transaction price reassessment requirements, at some point, the transaction price (and the revenue recognized) will be trued up to the actual outcome achieved.

Example D110.1

Transaction price is not a possible outcome of the contract

ABC Corp. enters into a contract for a large-scale software customization project with Customer (i.e. a software license and customization services). Customer wants to ensure the project is completed on a timely basis and, therefore, has built into the contract penalties for not meeting the agreed 'go live' date. The contract fees if ABC meets the agreed deadline are $130,000. If the project is not completed within three months of the deadline, the transaction price is reduced to $120,000. If the contract is not completed within five months of the deadline, the transaction price is further reduced to $110,000; completion any time after six months results in a transaction price of $100,000. However, if ABC completes the project more than three months *ahead* of schedule, the transaction price increases to $150,000.

Based on these contract terms, there are five possible outcomes for the transaction price – $150,000; $130,000; $120,000; $110,000; and $100,000.

ABC concludes that the contract includes only a single performance obligation (see Question C230) that is satisfied over time (see Question F200).

ABC decides that the expected value method is the most appropriate to estimate the transaction price given the number of possible outcomes and the fact that ABC enters into a large number of similar significant software implementation arrangements.

Using the expected value method, ABC assigns weightings to each possible outcome and estimates the transaction price (before consideration of the constraint) as follows.

Transaction price	Probability	Weighting
$100,000	5%	$5,000
110,000	10%	11,000
120,000	20%	24,000
130,000	50%	65,000
150,000	15%	22,500
Expected value		$127,500

ABC concludes that it does not need to further constrain the transaction price from the amount estimated using the expected value method. This is because the difference between the expected value of $127,500 and the amount to which ABC is probable of being entitled ($120,000 – i.e. ABC has an 85% likelihood of being entitled to at least $120,000) is not significant enough to have the potential to result in a *significant* revenue reversal given that the performance obligation will be satisfied over time.

Although $127,500 is not a possible outcome of the contract, ABC uses this amount as the transaction price at contract inception. In accordance with paragraph 606-10-32-14, ABC will continue to update the transaction price until the uncertainty associated with the project's completion is resolved.

Question D120

Should variable consideration be included in the transaction price when the entity believes it is unlikely to earn the variable consideration?

Interpretive response: It depends. An entity's objective when determining the transaction price for a contract is to estimate the total amount of consideration that it expects to be entitled to under the contract, subject to the constraint on variable consideration. If the entity concludes that using the most likely amount is the more appropriate approach and that amount is zero, then variable consideration would be excluded from the transaction price at contract inception. In contrast, if the entity concludes that using the expected value method is more appropriate, some amount of variable consideration (i.e. more than zero) will generally be included in the transaction price, even if the entity thinks it is unlikely to be entitled to any of the variable consideration, unless application of the constraint results in a minimum amount of zero.

Comparison to legacy US GAAP

Topic 606 differs from legacy US GAAP because under Topic 606, an entity is required to estimate variable consideration and include it in the transaction price if an entity concludes that it is probable that the estimate of variable consideration is not subject to a risk of significant revenue reversal.

Under legacy US GAAP, which is based on a realization concept, an entity assesses whether the fee is fixed or determinable. In many situations, entities concluded that the fee was not fixed or determinable until the underlying contingency was resolved.

Question D130

How does a pattern of granting price concessions to customers affect the transaction price?

Interpretive response: Price concessions generally refer to either:

- changes that would have affected the original amount of revenue recognized; or
- changes that reduce the arrangement fee or extend the terms of payment.

Changes that increase the promised goods or services or extend the customer's rights beyond those in the original transaction are not price concessions and the effect of such concessions is discussed in Question C90.

Examples of *price* concessions include, but are not limited to, the following:

- extending payment due dates in the arrangement;
- decreasing total payments due under the arrangement;
- paying financing fees on a customer's financing arrangement that was not contemplated in the original arrangement;
- accepting returns that were not required to be accepted under the terms of the original arrangement.

Anticipated price concessions affect the transaction price of a contract with a customer because the transaction price includes estimates of variable consideration, which includes any estimated price concessions. An entity with a history of granting price concessions should estimate the amount of consideration to which it expects to be entitled after consideration of any price concessions (i.e. using the expected value method or most likely amount method) and then should constrain that estimate to the extent it is both (1) more than remote (i.e. remote meaning 'unlikely to occur', and therefore the converse of 'probable', which is defined as 'likely to occur') additional concessions (beyond those factored into the expected value or most likely amount estimate) will be granted and (2) the effect of granting such additional concession(s) would be a significant revenue reversal (i.e. the change in the transaction price from the concession would result in a significant revenue reversal).

If a software entity grants a price concession where no previous pattern of such concessions has existed, and therefore, no concession was estimated in the initial transaction price, the entity would account for that price concession as a contract modification affecting price only (see *Chapter G – Contract modifications*). We would expect accounting for concessions as modifications to be relatively infrequent because it would generally not require an excessive number of such concessions before the entity should be factoring those previously granted concessions into the transaction price of future contracts.

If concessions, such as extending payment due dates or decreasing contract payments, occur due to customer credit problems, it may also follow that the entity should reassess whether a contract with the customer exists in accordance with paragraph 606-10-25-5.

Comparison to legacy US GAAP

See the discussion in Question C90.

Example D130.1

Pattern of granting price concessions and estimating the transaction price

ABC Corp. licenses ERP software to its customers, typically on a two-, three- or five-year term basis, with coterminous PCS services that are paid either annually or quarterly in advance. ABC is a second-tier player in the ERP software market, and therefore, has a significant incentive to try to ensure it keeps its existing customers from moving to one of the larger software providers. As a result, ABC has developed a practice of frequently providing its customers a discount on its PCS fees from those stated in the original contract for the final year. This discount has ranged from 20% to 60% with no discernible pattern and is generally expressed to the customer as a 'reward' for their past loyalty and is reflected on the applicable PCS invoice ABC sends for the discounted period.

ABC enters into a contract with Customer for a three-year license of its ERP software and concurrent PCS services for stated contractual fees of $300,000 for the three-year license (paid upfront) and $180,000 in total for three years of PCS, paid in three $60,000 installments at the beginning of each year ($480,000 in total contractual fees). The software license and the three years of PCS constitute two separate performance obligations, and ABC transfers the software license to Customer at contract inception.

ABC concludes that its substantive history of providing these PCS fee discounts requires it to include an estimate of the future discount it expects to provide Customer in the transaction price and to consider the constraint on variable consideration. ABC estimates the discount amount using an expected value method as there is no most likely discount amount, estimating that a discount of 42% in the third-year PCS fees will be granted. Consequently, absent consideration of the constraint, the transaction price at contract inception would be $454,800 ($480,000 – $25,200, which represents 42% of the $60,000 Year 3 PCS fees). Assuming the stand-alone selling prices of the license and the PCS are $300,000 and $200,000, respectively, the relative stand-alone selling price allocation would be as follows.

	Stand-alone selling price	**Relative stand-alone selling price**
License	$300,000	$272,880
PCS	$200,000	$181,920

Because ABC has a history of granting price concessions and those discounts can range, unpredictably (based on the entity's customary business practices and experience), between 20% and 60% of the final year's contractual PCS fees, including any of the potential PCS discount less than the 60% maximum in the transaction price carries the risk of a revenue reversal. However, ABC does not constrain its estimate of the transaction price below $454,800 because the revenue reversal that would result from the possible incremental discount of 18% (60% – 42%), or $10,800, regardless of when it occurs during the contract period, would not be significant to the cumulative revenue recognized to date under the contract. For example, an adjustment to the transaction price immediately after transfer of control of the software license would result in a reversal of only $6,480[1] (as compared to cumulative revenue recognized of $272,880), while an adjustment at the end of Year 2 of the contract (i.e. immediately before issuing the Year 3 PCS invoice), would only result in a reversal of $9,360[2] (as compared to cumulative revenue recognized of $394,160,[3] assuming a time-based measure of progress is applied to the three-year PCS performance obligation).

Notes:

1. $10,800 × ($272,880 ÷ $454,800) = $6,480.
2. $10,800 × ($394,160 ÷ $454,800) = $9,360.
3. $272,880 + ($181,920 × 2/3) = $394,160.

Question D140

How do customer price protection (i.e. retroactive most-favored nations) clauses affect the transaction price?

Price protection clauses

An entity may enter into an arrangement with an end customer or a reseller and agree to provide a rebate or credit for a portion of the arrangement fee in the event the entity reduces the price for the entity's products. This may include reseller scenarios where the reseller has not yet sold the products to end customers. These clauses may also apply to services or usage-based fees (e.g. a promise that if the entity offers better per-transaction pricing to another customer, that it will provide the customer a credit for the difference between what it paid and what the new customer is paying).

Interpretive response: Software entities should apply the price concession accounting model outlined in Question D130 (i.e. the variable consideration model). Because price protection clauses retroactively change the price paid for goods or services already transferred (e.g. licenses already transferred) or partially transferred (e.g. a partially completed software customization project) to the customer, they are, in essence, just another form of potential price concession.

Price protection clauses, which apply retrospectively, should be distinguished from most-favored nations (MFN) clauses that apply only prospectively to *distinct* promised goods or services (including distinct goods or services within a single performance obligation), or optional goods or services, not yet transferred to the customer. Such clauses do not create variable consideration. Rather, when the transaction price changes, the entity would account for the price change as a contract modification in accordance with paragraph 606-10-25-13(a).

Example D140.1

Reseller arrangement and price protection capped by the contract

ABC Corp. enters into a distribution agreement with Reseller on January 1, 20X1. The distribution agreement contains a clause that stipulates that in the event ABC reduces the price of any product in a transaction with a similarly situated customer, ABC will provide Reseller with a credit equal to the difference between the original purchase price and the new purchase price of the product for any units in Reseller's inventory at the time of the price reduction, as well as any units of the product purchased and sold by the Reseller within 180 days of the price reduction up to a maximum amount of 40% of the original purchase price.

On January 1, 20X1 (same day that the contract is entered into), ABC transfers control of 1,000 licenses of Product A for a nonrefundable fee of $100,000. At this same time, ABC's pricing committee is working to determine the amount of a price reduction for Product A licenses that would apply to similar customers.

Scenario 1

Because the pricing committee is evaluating a variety of considerations in attempting to determine the future pricing for licenses to Product A, there is significant risk in both the amount and the timing of the price concession that will be granted to Reseller. As a result of the significant uncertainty as to the price protection ABC will provide the Reseller, ABC concludes that only $60,000 of the $100,000 contract price is not subject to the risk of a significant revenue reversal – i.e. ABC assumes the maximum amount of price protection stipulated in the agreement with Reseller will be provided (i.e. at 40% of the $100,000 contract price). Consequently, the transaction price is only $60,000 at the point in time ABC transfers control of the 1,000 licenses to Reseller.

If ABC's pricing committee subsequently (e.g. April 1, 20X1) decides to reduce the price from $100 per license to $70 per license, and determines that no further price reductions are reasonably expected during the 180-day price protection period with Reseller, ABC would update its estimated transaction price for this contract from $60,000 to $70,000, and therefore, would recognize an additional $10,000 in revenue at that time.

Scenario 2

Alternatively, assume ABC's pricing committee is further along in its deliberations of the pricing for Product A licenses such that it is probable that the price reduction will not exceed 25% of the original $1,000 fee per license. In this case, the transaction price would be $75,000, which would be recognized at the point in time ABC transfers control of the 1,000 licenses to Reseller.

If ABC's pricing committee subsequently (e.g. February 1, 20X1) decides to reduce the price from $100 per license to $80 per license, and determines that no further price reductions are reasonably expected during the 180-day price protection period with Reseller, ABC would update its estimated transaction price for this contract from $75,000 to $80,000, and therefore, would recognize an additional $5,000 in revenue at that time.

Comparison to legacy US GAAP

The accounting for price protection clauses under Topic 606 will differ from that under legacy US GAAP as follows:

Software entity was unable to reasonably estimate effect of the price protection

Under legacy US GAAP, if the software entity was *unable* to reasonably estimate future price changes (e.g. in light of competitive conditions), or if significant uncertainties existed about the entity's ability to maintain its price, the arrangement fee was not fixed or determinable. In such circumstances, revenue from the arrangement was deferred until the entity was able to reasonably estimate the effects of future price changes.

Under Topic 606, the entity estimates the transaction price, subject to the constraint, generally resulting in at least some revenue recognition for transferred software licenses where no revenue would have been recognized under legacy US GAAP.

Software entity was able to reasonably estimate effect of the price protection

Under legacy US GAAP, if the software entity was *able* to reasonably estimate the amount of the fee that may be subject to rebate or forfeiture as a result of the entity reducing its price for a product, the entity generally would recognize revenue for the arrangement with a reserve established (classified as a reduction of revenue) for the estimated amount of the price concessions to be granted assuming all of the other legacy US GAAP software revenue recognition criteria were met.

This situation is similar to the requirements under Topic 606; however, legacy US GAAP differs from Topic 606 because, under legacy US GAAP in this scenario, a software entity would use its best estimate to determine the amount of revenue it could recognize when it delivered the software, while under Topic 606 the entity would have to consider the variable consideration constraint – i.e. incorporate a conservative bias to the determination of the transaction price. The conservative nature of the constraint versus a 'best estimate' may mean entities in this scenario would recognize less revenue at the time the software licenses are transferred to the customer under Topic 606 than they would have under legacy US GAAP.

Software entity was able to reasonably estimate, but estimated amount was unusually large

Under legacy US GAAP, even if the entity was able to reasonably estimate the amount of the fee, including within a narrow range, that may be subject to rebate or forfeiture as a result of the entity reducing its price for a product, it would also need to consider whether the amount (or narrow range) associated with the estimated price concession was unusually large. If so, the entity would evaluate whether revenue recognition was appropriate at all because an unusually large amount of estimated price protection may have been indicative of an arrangement granting the use of software for evaluation or demonstration purposes rather than an arrangement involving a valid sale. It might otherwise also call into question whether the fee is fixed or determinable.

While no revenue recognition might occur in these scenarios under legacy US GAAP, under Topic 606, the entity would generally recognize at least *some* revenue once it transferred control of the license because the transaction price will include the entity's estimate of the amount to which it will ultimately be entitled, which even if subject to the constraint will typically be an amount greater than zero.

Question D150

Do extended payment terms create variable consideration in a contract with a customer?

Extended payment terms

Extended payment terms in software arrangements have generally been defined as those in which payment of a significant portion of the license fee is not required until more than 12 months after software delivery; however, they can include any payment terms that are elongated from the entity's customary payment terms.

Interpretive response: Extended payment terms may be explicitly stated in a contract or they may be implied through an entity's past actions or customer expectations. Extended payment terms are not in and of themselves a form of variable consideration, provided those payment terms are fixed. However, contracts that feature extended payment terms may be more likely to include other forms of variable consideration. For example, the risk that an entity will grant a concession to the customer increases in situations where there are extended payment terms. This is because an entity's commitment to enforce payment may diminish if new or enhanced products are introduced by the entity or its competitors. This risk increases to the extent that the software is susceptible to rapid technological obsolescence. That is, if the underlying software is at risk of becoming technologically obsolete before a customer is required to make payment to the software entity, a concession becomes even more likely.

As part of their overall assessment of the risk of concessions, software entities generally should consider their historical collection history for sales of similar software licenses when estimating the frequency, extent and likelihood of potential price concessions for a group of contracts, or for a specific contract. If a contract, or group of contracts, have payment terms that are longer than a software entity typically offers for a given type of software product, then historical collection patterns may be a less useful predictive measure when estimating the likelihood and amount of potential price concessions. This may also be the case when a software entity enters a new market with a product that may have a different technological useful life than the entity's other products. The existence of extended payment terms and the payment term length offered to different customers could also be considered when applying an approach that uses a portfolio of data for the purposes of estimating payment concessions.

Software entities should apply the price concession accounting model outlined in Question D130 in accounting for any potential changes in the transaction price related to concessions arising from extended payment terms.

Even if a contract with extended payment terms does not give rise to a potential concession, contracts with extended payment terms may include a significant financing component that should be accounted for in determining the transaction price. The existence and accounting for significant financing components is discussed in the next section of this chapter.

Example D150.1
Extended payment terms

ABC Corp. enters into a five-year license to Software Product X with Customer for $1,500,000. Customer will pay that fee in equal quarterly installments over the five-year license period. ABC's current product development roadmap (which is not provided to Customer) shows that it expects to introduce a replacement software product to Product X before the end of the third year of the contract with Customer. The contract with Customer does not include rights to future when-and-if developed software products or any specified right to obtain a license to the expected replacement software product.

ABC does not have a history of granting price or other concessions to customers; however, it has not previously introduced a replacement of one of its core software products. Because Customer has no history of granting concessions, these circumstances of forthcoming product release alone may not mean a concession is reasonably possible, especially if there is a risk the replacement product will not be developed and released on schedule. If the likelihood of a concession is remote, then it may have no effect on the transaction price. This is because it would be probable that *no* concession will be granted (i.e. it is probable that no significant revenue reversal would result from use of the stated contract price, without consideration of a possible concession, as the transaction price). It should be noted that use by ABC of an expected value estimation technique could still result in a reduction of the transaction price for the effect of a concession (e.g. if there is a chance of a concession that is more than 'remote'). However, given no history of concessions in similar arrangements, ABC might conclude an expected value method is not appropriate or may conclude, consistent with Question D50, that it does not need to include the remote possibility of granting a concession in its expected value determination.

ABC needs to apply judgment in this example to determine whether the likelihood of a concession is more than remote (e.g. whether ABC might grant Customer a license to the replacement software product, reduce Customer's remaining payments for its Product X license after the replacement product is released or grant Customer X a discounted license to Product X). Individual facts and circumstances could significantly affect the conclusion. For example, accounting for a possible concession (whether a price concession or otherwise, such as a license to the replacement software product) would likely be appropriate if ABC's management is discussing possible concessions or incentives that should be offered in order to retain customers like Customer who might be on term licenses to the older Product X when the replacement product is released. Question C90 addresses the accounting for concessions consisting of free or discounted goods or services, while Question D130 addresses *price* concessions. ABC will also need to consider whether the extended payment terms for the five-year software license mean the contract includes a significant financing component. Significant financing components are discussed in beginning with Question D230.

Comparison to legacy US GAAP

Legacy US GAAP contained considerable guidance, including implementation guidance, on the effect of extended payment terms in software arrangements. In general, legacy US GAAP specified that an arrangement fee should be presumed not to be fixed or determinable if payment of a significant portion of the licensing fee is not due until after expiration of the license or more than 12 months after delivery. That presumption could be overcome by evidence that the entity had a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions (paragraphs 985-605-55-22 through 55-25).

If, at the outset of an arrangement, an entity concluded that the arrangement fee was not fixed or determinable, the entire fee would be recognized only as payments became due and payable, assuming all other revenue recognition criteria were met. In addition, legacy US GAAP provided that:

— A modification of payment terms at a subsequent date would not trigger a reassessment of whether the fees were fixed or determinable. However, in cases where an existing arrangement with a customer was replaced by a substantially new arrangement (e.g. the entity and the customer contract for substantial additional deliverables with an appropriate corresponding increase in aggregate fees), it was considered appropriate to reassess whether the fees were fixed or determinable at inception of the new arrangement.

— In an extended payment terms scenario where the entity recognizes revenue as the payments became due and payable, an entity could recognize revenue at the time the prepayments were received (i.e. before they were due and payable under the terms of the original contract) provided all other revenue recognition criteria were met (paragraph 985-605-55-15).

— If an entity entered into a software arrangement with extended payment terms, and then received payment in full subsequent to its financial reporting period-end, but before issuing its financial statements for that period, it was not appropriate to reassess whether the fees were fixed or determinable at period-end (i.e. this subsequent payment would not allow the software entity to recognize the license fees in the reporting period that just ended). The entity would recognize the license fees as revenue of the period in which they were paid (paragraphs 985-605-55-26 through 55-30).

— The presumption that a software license fee was not fixed or determinable (e.g. under an extended payment terms scenario) was *not* overcome if, whether at the outset of the arrangement or subsequently, the software entity transferred its rights to receive amounts due under an extended payment term arrangement to an independent third party. This transfer did not change the nature or structure of the transaction between the software entity and customer, even if the extended payment term arrangement is irrevocably transferred or otherwise converted to cash without recourse to the entity (paragraphs 985-605-55-31 and 985-605-55-32).

Under Topic 606 there is not a fixed or determinable criterion for revenue recognition, and therefore extended payment terms do not create the presumption of a price concession. And even where a concession may be expected because of extended payment terms, the accounting for expected price or other concessions under Topic 606 will generally not delay revenue recognition under the contract as significantly as the expectation of concessions did under legacy US GAAP. That is, entities that expect to grant price or other concessions under a contract will generally recognize revenue for that contract in advance of when they would have been able to recognize revenue for that same contract under legacy US GAAP. See further discussion in Question C90.

Question D160

How should prompt payment discounts be considered when determining the transaction price of a contract?

Interpretive response: Contracts with customers often have terms that incentivize prompt payment by the customer such as '2/10 net 30' (2% discount for payment to an entity within 10 days or pay the full invoice amount within 30 days). The potential 2% discount is variable consideration that affects the transaction price in the same manner as any other variable consideration.

As such, the entity would make an estimate of the consideration it expects to be entitled to as a result of offering these terms using the most likely amount or the expected value method. Consistent with the overall variable consideration model, the entity would analyze their experience with similar customers and transactions in making this estimate and that estimate would then be subject to the variable consideration constraint.

Question D165

Are liquidated damages or similar provisions variable consideration?

Interpretive response: Generally, yes. Many contracts contain terms providing for liquidated damages and similar compensation to the customer upon the occurrence or nonoccurrence of certain events. These terms typically give rise to variable consideration, given the standard identifies penalties as variable consideration.

However, in some circumstances the terms may be similar to a warranty provision. Judgment is required to distinguish those terms that are accounted for as warranties from the more common scenarios in which the terms give rise to variable consideration.

For example, if a third party repairs a defective product sold by an entity and the entity reimburses the customer for costs incurred, that may be similar to a warranty. Those payments to a customer are typically accounted for as an assurance-type warranty rather than variable consideration. Similarly, the payments are typically not treated as consideration payable to a customer because the payments provide the entity with an identifiable benefit of repairing the goods or services initially provided to the customer.

Question D170

How do service level agreements (SLAs) that could result in refunds or credits to the customer affect the transaction price?

Interpretive response: Credits or refunds to a customer that result from the failure of the entity to meet certain standards under the contract are adjustments to the transaction price (reductions of revenue), and therefore they should be estimated at the outset of the arrangement in the same manner as any other variable consideration – i.e. using the most likely amount or the expected value method. As with other forms of variable consideration, those estimates are then subject to the constraint on variable consideration. The estimates, including the effect of the constraint on those estimates, are revised and the transaction price adjusted until the uncertainty is resolved.

Example D170.1

Service level agreements

SaaS Company enters into a standard contract with Customer to provide access to its hosted application for three years. Monthly fees are $100 throughout the three-year term, subject to a service level provision under which SaaS Company warrants that the hosted application will be available and functioning to specifications during the service period at least 99% of the time (i.e. the maximum percentage of downtime for maintenance or due to increased network traffic will be 1%). In any month that the downtime is greater than 1%, Customer will be entitled to a 10% credit of that month's fees against the next month's $100 payment – i.e. Customer will pay $90 in any month following a month in which downtime is greater than 1%. In addition, if the downtime is greater than 5%, SaaS Company will be required to provide a 25% credit of that month's fees in the next month.

Scenario 1

SaaS Company has significant experience with similar contracts and has an established history of *rarely* having to grant service level credits to customers. Based on this significant experience, SaaS Company concludes that using the most likely amount method to estimate the variable consideration in the contract resulting from the possible service level credits will best predict the consideration to which it will be entitled. Applying that method, SaaS Company concludes that it expects to be entitled to 100% of the contract price (i.e. downtime will be less than 1% for the duration of the agreement because it does not expect to issue any credits or refunds). Further, SaaS Company's experience is of such a substantive nature and so rarely has to grant service level credits that the estimate of variable consideration does need to be constrained – i.e. it is probable that including the entire stated fees for the three-year term of $3,600, without any reduction for possible service level credits, in the transaction price at contract inception will not result in a significant revenue reversal. Consequently, the transaction price does not reflect any expectation of service level credits.

Scenario 2

SaaS Company has been operating for a relatively short period of time such that its experience with these types of arrangements is limited. Consequently, SaaS Company cannot conclude that it is probable it will not grant any service level credits to Customer during the course of the contract and will need to estimate expected service level credits over the three-year term. SaaS Company considers all of its available and relevant evidence, including knowledge about the quality of its infrastructure, industry benchmarks and its own limited experience in developing an expected value method to estimate the credits it expects to provide to Customer over the three-year term. SaaS Company further considers whether it is probable, if it uses that estimate as the transaction price, that no significant revenue reversal will result.

ABC will continue to re-evaluate its estimate of the transaction price, including the effect of the constraint (if applicable), at the end of each reporting period for changes in circumstances (e.g. additional experience gained).

Question D175

Does an entity first estimate variable consideration and then apply the constraint to that estimate?

Interpretive response: Not necessarily. An entity isn't required to strictly follow the two-step process if its process for estimating variable consideration already incorporates the principles on which the guidance for constraining estimates of variable consideration is based.

For example, when an entity estimates revenue from sales of goods with a right of return, it might not practically need to estimate the expected revenue and then apply the constraint guidance to that estimate. This will be the case if its calculation of the estimated revenue incorporates its expectations of returns at a level at which it is probable that the cumulative amount of revenue recognized would not result in a significant revenue reversal. [ASU 2014-09.BC215]

If an entity decides not to strictly follow the two-step approach, it is nevertheless important that its estimated transaction price includes its expectations of the amount of variable consideration that is probable of not being subject to a significant reversal of the cumulative revenue recognized.

Question D176

Is the unit of account for determining the constraint at the contract or performance obligation level?

Interpretive response: Contract level. The unit of account for determining the transaction price, and therefore the constraint, is at the contract level – it is not at the performance obligation level. While this is not explicitly stated in the standard, the TRG agreed that the unit of account for applying the constraint is the contract. [TRG Agenda Paper No. 14]

Question D180

What factors influence the potential magnitude of a revenue reversal that would result from a downward adjustment to an entity's estimate of variable consideration?

Interpretive response: Because the constraint is intended to significantly reduce the likelihood that a *significant* reversal in the amount of *cumulative* revenue recognized *for the contract* will occur (i.e. it considers the magnitude of any potential revenue reversal), the following affect (1) whether the constraint results in an adjustment to the entity's most likely amount or expected-value method estimate of variable consideration and, if so, (2) the amount of that adjustment.

— The identification of the performance obligations in the contract (e.g. whether a license and professional services are or are not distinct).
— If there are multiple performance obligations in the contract, the order in which those performance obligations are satisfied.
— Whether some or all of the performance obligations in the contract are satisfied over time or at a point in time.

Example D180.1

Effect of various scenarios on the potential magnitude of a revenue reversal

This example outlines three scenarios in order to illustrate how the above-outlined factors affect the potential magnitude of a revenue reversal resulting from a change in the amount of estimated variable consideration.

Scenario 1

ABC enters into a contract with Customer that includes a software license and implementation services that are separate performance obligations. The software license is transferred at contract inception and the implementation services are provided over the subsequent 12 months. The fixed consideration is $1,000,000, and ABC can earn up to a $200,000 bonus depending on when the implementation services are completed. Based on the stand-alone selling prices of the license and the services, determined using a residual approach and the observable stand-alone selling price, respectively (see *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*); the transaction price is allocated on an 80:20 ratio to the license and implementation services, respectively.

On a most likely amount basis, ABC concludes that it expects to be entitled to $150,000 of the performance bonus. However, it is only 'probable' that ABC will be entitled to $50,000. Assume ABC concludes that it cannot allocate the performance bonus to only the license or the implementation services.

Because the distinct software license is transferred to Customer at contract inception, if ABC were to include $150,000 of variable consideration in the transaction price at contract inception (i.e. if ABC were *not* to constrain any of its most likely estimate of variable consideration), and later have to revise its estimate to the probable amount of $50,000, ABC would record a revenue reversal of *at least* (i.e. depending on progress toward satisfaction of the implementation services at the time the estimate is revised) $80,000 ($100,000 [$150,000 – $50,000] × 80%). The portion of the remaining $20,000 of the change in the transaction price ($100,000 – $80,000) that will be immediately reversed against revenue depends on ABC's completion of the implementation services when the change in the transaction price occurs (e.g. if ABC is 50% complete with the implementation services, ABC's total revenue reversal will be $90,000 [$80,000 attributable to the license; $10,000 attributable to the services]).

Because the potential revenue reversal could be significant, ABC concludes that the variable consideration constraint should be applied.

Scenario 2

ABC enters into a contract with Customer that includes a software license and customization services that are a single, combined performance obligation. The combined performance obligation is satisfied over time and is expected to be satisfied over 12-15 months after contract inception. The fixed consideration is $1,000,000; and ABC can earn up to a $200,000 bonus depending on when the software customization is completed.

On a most likely amount basis, ABC concludes that it expects to be entitled to $150,000 of the performance bonus. However, it is only 'probable' that ABC will be entitled to $50,000.

If ABC were to include $150,000 of variable consideration in the transaction price at contract inception, and later have to revise its estimate to the probable amount of $50,000, ABC's revenue reversal at that point in time would be less than that in Scenario 1 and would depend on ABC's progress toward satisfaction of the performance obligation. For example:

% Complete	Revenue reversal
10%	$10,000
25%	$25,000
60%	$60,000

Consequently, the magnitude of the revenue reversal that would result from a potential downward adjustment in ABC's estimate of variable consideration to which it expects to be entitled in this scenario is less significant throughout the contract period than in Scenario 1. As a result, ABC concludes that it does not need to constrain its estimate of the variable consideration to which it expects to be entitled and includes the entire $150,000 estimate in the contract inception transaction price.

Scenario 3

Assume the same facts and circumstances as Scenario 2 except that the single, combined performance obligation is satisfied at a point-in-time (e.g. due to highly specialized customer acceptance provisions – see Question F210) upon completion of the software customization.

On a most likely amount basis, ABC concludes that it expects to be entitled to $150,000 of the performance bonus. However, it is only 'probable' that ABC will be entitled to $50,000.

In this scenario, the constraint would not result in an adjustment to the transaction price because no revenue will be recognized until the uncertainty giving rise to the variable consideration is resolved – i.e. because no revenue will be recognized until the performance obligation is completely satisfied, *no* cumulative revenue will have been recognized at the point in time any downward adjustments to ABC's estimate of the variable consideration to which it expects to be entitled are made.

Note: Based on the above, software entities should be aware that the constraint is more likely to apply in arrangements where a distinct software license is transferred to the customer upfront and a significant portion of the transaction price is allocated to that upfront software license – i.e. unless the source of the variable consideration is a sales- or usage-based royalty, to which the constraint on variable consideration does not apply (see below). As illustrated in the example, Scenario 1, a change in the estimate of, for example, a performance bonus on distinct implementation services would not only affect revenue recognized to-date for the partially completed implementation services, but also for the already-transferred software license.

Question D185

How does an entity account for a change in estimate that results in a significant revenue reversal?

Interpretive response: While it was the standard's intention that in most cases changes to variable consideration would be an upward (an increase in the transaction price) or an insignificant downward revision, there may be circumstances in which the change in estimate results in a *significant* reversal when compared to the cumulative revenue recognized. The threshold for determining whether a significant reversal would occur is 'probable' and not 'virtually certain'; as such the standard allows for a reasonable possibility that a significant reversal will occur.

If the significant reversal is due to new facts or circumstances that were not available at the time of the initial estimate, the change is accounted for as a change in estimate just like any other change in the transaction price. This might be the case if an entity estimated a usage-based fee in a service contract for which it had extensive experience with the customer (and similar customers) but unexpected circumstances subsequently led to the customer losing market share resulting in the usage of the service significantly declining.

Notwithstanding the paragraph above, an entity needs to evaluate whether the change is a change in estimate or the result of an error in accordance with Topic 250 (accounting changes and error corrections). If the change is a result of a misunderstanding of the facts and circumstances that were reasonably available when making the initial estimates, the entity would have an accounting error and would need to assess the materiality and any related correction to current and prior periods to determine the appropriate process for correcting the error.

Sales- and usage-based royalties

Variable consideration in the form of a sales- or usage-based royalty that is promised in exchange for a *license* of intellectual property (e.g. a software license) is not subject to the constraint on variable consideration. Rather, such royalties are subject to a specific sales- and usage-based royalties *recognition* exception ('the royalties constraint') that is further discussed in *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*.

The royalties constraint does not apply to either:

- *sales* of intellectual property (e.g. the sale of a software application and all related rights to that application to another party); or
- usage-based fees in SaaS arrangements because, as described in *Chapter A – Scope*, SaaS arrangements do not include a license to software.

Sales- and usage-based fees promised in exchange for the sale of intellectual property or included in SaaS arrangements are subject to the general guidance on variable consideration, including the constraint on variable consideration, outlined earlier in this chapter.

When determining the applicability of the royalties constraint, an entity should not attempt to discern whether a license to intellectual property is an 'in substance sale' of that intellectual property. The FASB reached this conclusion on the basis that attempting to distinguish between licenses that are, or are not, in substance sales would add significant complexity (i.e. trying to distinguish what licenses constitute in substance sales) and that it may be inappropriate to ignore, for accounting purposes, legal differences between a contract for a license and a contract for an outright sale of intellectual property. [ASU 2016-10.BC78(b)].

Comparison to legacy US GAAP

Variable consideration that is not a sales- or usage-based royalty promised in exchange for a license

Under legacy US GAAP, arrangement fees were not recognized as revenue until they were fixed or determinable and any fees contingent on future performance (e.g. delivery of an additional good or service) were deferred until the contingency was resolved (the 'contingent cash cap').

Topic 606 does not require fees to be fixed or determinable and does not have a contingent cash cap, rather Topic 606 follows the estimation and constraint guidance described above. The change in the guidance pertaining to variable/contingent consideration will likely result in many entities recognizing revenue earlier than they did under legacy US GAAP and also require many entities to implement new processes and controls in order to permit them to meet the new estimation requirements and make the judgments necessary to apply the constraint.

Sales- or usage-based royalties promised in exchange for a license

See *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*.

Sell-in vs sell-through

Under legacy US GAAP, some software entities that sell their software licenses through distributors or resellers conclude that the fees for its sales to distributors or resellers are not fixed or determinable because of the risk of granting price concessions or of accepting returns. Those entities recognize revenue upon 'sell-through' of the software license to the end customer (i.e. when an end customer obtains the software from the reseller).

In contrast, under Topic 606, an expectation of price concessions or returns is variable consideration. And because variable consideration does not affect the timing of revenue, which is recognized when or as the performance obligation is satisfied, only the amount, software entities in distributor or reseller arrangements cannot default to a sell-through method. Under Topic 606, the software entity is generally required to determine the total amount of consideration to which it expects to be entitled (e.g. the number of units it expects not to be returned and the amount it expects to be entitled to, after any price concessions, for those units), subject to the variable consideration constraint. The entity recognizes that amount at the time control of the license(s) transfers to the distributor or reseller. Sell-through (or a result approximating sell-through) would typically not be appropriate unless:

— control of the licenses has not transferred to the distributor or reseller – e.g. certain (substantive) repurchase rights of the entity that exist in some distributor relationships to buy back a good until the point in time it is sold to an end customer will affect when control of the license transfers; or

— by applying the constraint, the amount recognized upon transfer of control of the licenses to the distributor or reseller is zero (which will not usually be the case) – i.e. the entire amount of consideration is at risk of a significant revenue reversal (which would be an infrequent fact pattern). Given that the entity needs to update its assessment of whether an estimate of the amount is constrained, and if so, by how much, at each reporting date, even if the initial transaction price is zero at the point in time control transfers to the distributor or reseller, the transaction price likely will be updated to an amount above zero, and revenue recognized, before sell-through occurs.

The transaction price is updated each reporting period until the uncertainty for concessions and returns is resolved.

As a result, it is likely that revenue will be recognized on many sales to distributors or resellers earlier under Topic 606 than it was under legacy US GAAP.

Question D190

Are subsequent sales or usage of licensed software variable consideration or is each subsequent sale or usage an 'optional purchase'?

See Question C380 in *Chapter C – Step 2: Identify the performance obligations in the contract*.

Question D200

Is the contractual right to acquire additional users, seats or copies of software a sales- or usage-based fee (i.e. variable consideration) or a customer option to acquire additional software licenses?

See Question C390 in *Chapter C – Step 2: Identify the performance obligations in the contract*.

Question D210

Are SaaS providers required to estimate transaction-based fees that will be earned from customers in SaaS arrangements?

Interpretive response: It depends. Transaction-based fees (e.g. fees charged for each use by the customer, or the customer's customer of the SaaS provider's application) are just one *form* of variable consideration (see Question C400 for discussion of options to add users or seats in a SaaS arrangement). Therefore, SaaS providers are required to estimate such fees, just as they would other forms of variable consideration (e.g. service level agreements – see Question D170), unless they meet one of two conditions; either:

— the 'as-invoiced' practical expedient in paragraph 606-10-55-18 can be applied that permits an entity to recognize revenue from items like transaction-based fees in the amount to which it has a right to invoice the customer. This applies if that amount corresponds directly with the value to the customer of the entity's performance completed to date. A significant upfront fee or a usage-based fee rate that changes during the contract period in a manner that cannot be directly linked to a change in value of the entity's services to the customer may preclude use of this expedient. *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation* discusses in further detail when use of this practical expedient is, and is not, appropriate.

— the SaaS performance obligation is determined to be a series of distinct service periods (e.g. a series of distinct daily, monthly or annual periods of service) – which will generally be the case (see the Overview section of *Chapter C – Step 2: Identify the performance obligations in the contract*), and allocation of the fees earned to each distinct service period based on the customer's usage each period would reasonably reflect the fees to which the entity expects to be entitled for providing the SaaS for that period. Consistent with the as-invoiced practical expedient, a usage-based fee rate that differs from period to period during the contract may prevent allocation of the fees earned in a single distinct service period to that period, as might a discount or rebate that is based on metrics that cross multiple distinct service periods. However, unlike the as-invoiced practical expedient, an upfront fee generally will not affect whether this condition is met. *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract* discusses when SaaS providers will and will not be able to allocate transaction-based fees to distinct service periods within a SaaS performance obligation.

Question D220

How do volume-based discounts and rebates affect the estimation of the transaction price in SaaS arrangements?

Interpretive response: First, transaction- and usage-based pricing should be distinguished from customer options to add users or seats (see Question C400).

SaaS arrangements that include transaction- or usage-based fees often include tiered pricing and/or volume rebates or credits. The following are examples.

— Per transaction pricing that decreases *prospectively* as the customer makes greater use of the provider's platform (e.g. $0.10 per transaction for the first 100 transactions; $0.09 per transaction for the next 100; and $0.075 per transaction for those above 200).

— Per transaction pricing that decreases as the customer makes greater use of the provider's platform on a *retrospective* basis. For example, the customer is required to pay $0.10 per transaction for the first 100 transactions, and if the customer reaches that milestone it will pay $0.09 on all transactions going forward *and* receive a rebate (or credit toward future transaction fees) of $0.01 on the first 100 transactions processed.

Pricing arrangements such as these sometimes apply to an entire contract term or to distinct periods within the contract. For example, a tiered-pricing or volume rebate/credit structure may apply to each month, quarter or year within a longer-term SaaS arrangement and reset at the beginning of the next distinct period. These are just examples as there are many different transaction- and usage-based pricing structures that exist and they frequently co-exist with varied fixed price components.

In general, transaction-based fees in a SaaS arrangement constitute variable consideration, rather than optional purchases (see Question C380). The complexity of the pricing structure (e.g. the presence of pricing tiers, rebate/credit provisions and resets) does not change that, but *may* influence whether the SaaS provider can make use of either approach described in Question D210 to avoid having to estimate that variable consideration – i.e. the less 'vanilla' the transaction-based pricing structure, the more likely the provider will have to undertake some measure of estimation of the variable consideration in order to recognize revenue on the arrangement under Topic 606. *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract* discusses in further detail the effect of these types of pricing structures on the SaaS provider's ability to apply the variable consideration allocation guidance.

If the SaaS provider is required to estimate the variable consideration in the arrangement – whether for the entire contract term or just for a distinct period within the overall contract term – possible refunds, rebates or credits will factor into the estimate of variable consideration, just as the expected transaction volume will. Multiple variables – i.e. variable usage and variable pricing – will increase the complexity of the estimation process and likely result in more variability throughout the contract term, meaning entities in these situations may have to undertake multiple re-estimations of the transaction price over the course of the contract (and likely more so in circumstances where the estimation period is the entire contract term or a longer distinct period within the contract term, such as a year versus a quarter or month).

The existence of a significant financing component in the contract

Excerpt from ASC 606-10

>> The Existence of a Significant Financing Component in the Contract

32-15 In determining the transaction price, an entity shall 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. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

32-16 The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize **revenue** at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price). An entity shall 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
b. The combined effect of both of the following:
    1. 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
    2. The prevailing interest rates in the relevant market.

32-17 Notwithstanding the assessment in paragraph 606-10-32-16, a contract with a customer would not have a significant financing component if any of the following factors exist:

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).
c. The difference between the promised consideration and the cash selling

price of the good or service (as described in paragraph 606-10-32-16) 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, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

32-18 As a practical expedient, 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.

32-19 To meet the objective in paragraph 606-10-32-16 when adjusting the promised amount of consideration for a significant financing component, an entity shall 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 shall 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).

32-20 An entity shall present the effects of financing (interest income or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income (statement of activities). Interest income or interest expense 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. In accounting for the effects of the time value of money, an entity also shall consider the subsequent measurement guidance in Subtopic 835-30, specifically the guidance in paragraphs 835-30-45-1A through 45-3 on presentation of the discount and premium in the financial statements and the guidance in paragraphs 835-30-55-2 through 55-3 on the application of the interest method.

>>> Example 28—Determining the Discount Rate

55-235 An entity enters into a contract with a customer to sell equipment. Control of the equipment transfers to the customer when the contract is signed. The price stated in the contract is $1 million plus a 5 percent contractual rate of interest, payable in 60 monthly installments of $18,871.

>>>> Case A—Contractual Discount Rate Reflects the Rate in a Separate Financing Transaction

55-236 In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 5 percent contractual rate of interest reflects the rate that would be used in a separate financing transaction between the entity and its customer at contract inception (that is, the contractual rate of interest of 5 percent reflects the credit characteristics of the customer).

55-237 The market terms of the financing mean that the cash selling price of the equipment is $1 million. This amount is recognized as revenue and as a loan receivable when control of the equipment transfers to the customer. <u>The entity accounts for the receivable in accordance with Topic 310 on receivables and Subtopic 835-30 on the imputation of interest.</u>

>>>> Case B—Contractual Discount Rate Does Not Reflect the Rate in a Separate Financing Transaction

55-238 In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 5 percent contractual rate of interest is significantly lower than the 12 percent interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception (that is, the contractual rate of interest of 5 percent does not reflect the credit characteristics of the customer). This suggests that the cash selling price is less than $1 million.

55-239 In accordance with paragraph 606-10-32-19, the entity determines the transaction price by adjusting the promised amount of consideration to reflect the contractual payments using the 12 percent interest rate that reflects the credit characteristics of the customer. Consequently, the entity determines that the transaction price is $848,357 (60 monthly payments of $18,871 discounted at 12 percent). The entity recognizes revenue and a loan receivable for that amount. <u>The entity accounts for the loan receivable in accordance with Topic 310 on receivables and Subtopic 835-30 on the imputation of interest.</u>

Pending Content

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* ¦ **Transition Guidance:** 326-10-65-1

55-237 … The entity accounts for the receivable in accordance with Topic 310 on receivables, Subtopic 326-20 on financial instruments measured at amortized cost, and Subtopic 835-30 on the imputation of interest.

55-239 … The entity accounts for the loan receivable in accordance with Subtopic 310-10 on receivables, Subtopic 326-20 on financial instruments measured at amortized cost, and Subtopic 835-30 on the imputation of interest.

>>> Example 30—Advance Payment

55-244 An entity, a technology product manufacturer, enters into a contract with a customer to provide global telephone technology support and repair coverage for three years along with its technology product. The customer purchases this support service at the time of buying the product. Consideration for the service is an additional $300. Customers electing to buy this service must pay for it upfront (that is, a monthly payment option is not available).

55-245 To determine whether there is a significant financing component in the contract, the entity considers the nature of the service being offered and the purpose of the payment terms. The entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to maximize profitability, taking into consideration the risks associated with providing the service. Specifically, if customers could pay monthly, they would be less likely to renew, and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (that is, customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs). In addition, customers tend to use services more if they pay monthly rather than making an upfront payment. Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments.

55-246 In assessing the guidance in paragraph 606-10-32-17(c), the entity determines that the payment terms were structured primarily for reasons other than the provision of finance to the entity. The entity charges a single upfront amount for the services because other payment terms (such as a monthly payment plan) would affect the nature of the risks assumed by the entity to provide the service and may make it uneconomical to provide the service. As a result of its analysis, the entity concludes that there is not a significant financing component.

Topic 606 requires an adjustment for the effect of a financing component (time value of money) if the financing component is significant to the contract. The requirement to adjust for a significant financing component (i.e. the time value of money) reflects the fact that:

- entities are not indifferent to the timing of cash flows in a contract (i.e. cash now is more valuable than cash later);
- exclusion of the financing component could misrepresent the profit in the contract (e.g. a payment made in arrears would result in full profit upon transfer of the good or service, even though the entity bears ongoing cost of financing to the customer, conversely, a payment made in advance would result in the financing cost that the entity incurs being included in gross profit from the sale of the good or service); and
- contracts with an explicitly stated interest rate (where interest income is recognized) should not be treated differently from contracts with an implied interest rate.

Identifying a significant financing component

Generally, a contract has a financing component if the promised amount of consideration differs from the cash-selling price of the promised goods or services or there is a significant timing difference between when control of the goods or services is transferred to the customer and when the customer pays for the goods or services. The financing component may be explicit, where a stated interest rate is charged, or implied – i.e. the amount of consideration payable to the entity would differ if the customer paid cash at the same time as it received the good or service. Whether that financing component is 'significant' to the contract and must be factored into the determination of the transaction price is a matter of judgment.

Two factors should be considered in determining whether a financing component is significant to the contract:

Relevant facts and circumstances

a) Difference between the amount of promised consideration and the cash selling price

b) Combined effect of:

1. Expected length of time between when the entity transfers the promised goods or services and when the customer pays

2. Prevailing interest rates in the relevant market

The significance of a financing component is determined at the contract level only, rather than for each performance obligation or at an aggregated portfolio level – i.e. an entity does *not* evaluate whether the combined effects of individually insignificant financing components would be material to a portfolio of contracts or to the entity's financial statements as a whole.

Even if a financing component is not significant, the TRG members agreed at the March 2015 meeting that an entity is not precluded from accounting for that component following the significant financing guidance.

A contract does not have a significant financing component if any of the following factors exists.

Factor	Example
An entity receives an advance payment, and the timing of the transfer of goods or services to a customer is at the discretion of the customer	A flexible spending arrangement where the customer pays the entity a fixed amount upfront and the customer draws down against that prepaid amount (e.g. issues purchase orders to acquire various software licenses and related services) at its discretion over the term of the arrangement.
A substantial portion of the consideration is variable, and the amount or timing of the consideration is outside the customer's or entity's control	A software license transferred to the customer at contract inception that the customer will embed in its products and the consideration for the software license is a sales-based royalty.
The difference between the amount of promised consideration and the cash selling price of the promised goods or services arises for non-finance reasons	Protection against the counterparty not completing its obligations under the contract

Determining whether a difference between the amount of promised consideration and the cash selling price of the goods or services arises for reasons other than the provision of finance requires judgment. An entity considers all relevant facts and circumstances, including whether the difference is proportionate to any other reason provided – i.e. in addition to having a reason other than financing, paragraph 606-10-32-17(c) requires the difference between the promised consideration and the cash selling price of the good or service to be proportional to the reason for the difference.

A payment in advance or arrears on terms that are typical for the industry and jurisdiction *may* have a primary purpose other than financing. For example, a customer may withhold an amount of consideration that is payable only on successful completion of the contract or the achievement of a specified milestone (e.g. successful implementation or customization of software). The primary purpose of these payment terms, as illustrated in Example 27 of Topic 606, may be to provide the customer with assurance that the entity will perform its obligations under the contract, rather than provide financing to the customer. An entity should monitor practices within its industry and geography (including its own customary payment terms) and consider documenting how the payment terms in certain contracts conform to these practices and whether, if at all, the primary purpose of these practices is other than financing (e.g. retainage). When considering practices within its industry and geography (including its own customary payment terms) entities should use current actual transaction data and contracts with similar terms to the contract under consideration. Importantly, the fact that payment in advance or arrears is typical for an industry or in a jurisdiction is not determinative that such payment occurs for non-finance reasons – i.e. the fact that such payment terms are typical for the industry or the jurisdiction does not automatically mean there is not a significant financing component in the contract.

Although it seems that the Boards were attempting to address retention payments in the construction industry with these observations, this concept might apply to other situations (e.g. long-term software customization or implementation projects that may have some characteristics similar to many long-term construction contracts). The Boards explicitly considered advance payments received by an entity during their redeliberations – e.g. compensating the entity for incurring upfront costs – but decided not to exempt entities from accounting for the time value of money effect of advance payments when the embedded financing is significant to the contract with the customer.

Accounting for a significant financing component

When a contract includes a significant financing component as a result of an advance payment to the entity, the accounting effect of the financing component increases the amount of revenue recognized, with a corresponding increase to interest expense because the customer has provided financing to the entity. Conversely, when a contract includes a significant financing component because the entity receives payments in arrears, the adjustment for the financing component decreases the amount of revenue recognized with a corresponding increase to interest income because the entity has provided financing to the customer.

These effects impact various financial metrics such as EBITDA (earnings before interest, tax, depreciation and amortization), which may, in turn, affect compensation and other contractual arrangements.

The effects of a significant financing component are reflected in the entity's estimate of the transaction price as either an increase (for advanced payments) or a decrease (in post-paid scenarios) using a discount rate that reflects the credit standing of the party receiving the financing (i.e. the entity's credit standing for advance payment circumstances and the customer's credit standing for payments in arrears).

Determining the effect of the time value of money for a contract with a significant financing component can be complex for long-term or multiple-element arrangements. In these contracts:

- goods or services are transferred at various points in time;
- cash payments may be made throughout the contract; and
- there may be a change in the estimated timing of the transfer of goods or services to the customer.

If additional variable elements are present in the contract – e.g. contingent consideration – then these calculations can be even more complicated.

For example, a software entity may offer payment terms that allows customers to buy software products and pay the cash selling price two years after delivery. Judgment is required to evaluate whether in these circumstances an entity is offering a discount or other promotional incentive for customers who pay the cash selling price at the end of the promotional period equal to the financing charge that would otherwise have been charged in exchange for financing the purchase.

If the entity concludes that financing has been provided to the customer, then the transaction price is reduced by the implicit financing amount and interest income is accreted. The implicit financing amount is calculated using the rate that would be used in a separate financing transaction between the entity and its customer commensurate with the customer's credit standing.

Determining the discount rate

The discount rate to be used in accounting for a significant financing component:

- is determined at contract inception and is not updated for changes in interest rates or changes in facts or circumstances, such as the customer's or the entity's credit standing (however, the discount rate is updated if there is a contract modification not accounted for as a separate contract and a significant financing component is determined to exist in the modified contract); and

- is the rate that would be reflected in a separate financing transaction between the entity and the customer, reflecting the credit characteristics of the party (i.e. the entity or the customer) receiving the financing.

For payments received in advance of the transfer of the goods or services to the customer, the discount rate used should reflect the creditworthiness of the entity. Conversely, for payments received in arrears (i.e. after the transfer of the goods or services to the customer), the discount rate used should reflect the creditworthiness of the customer and any effect on the rate (presumably downward) if collateral or other security is provided by the customer.

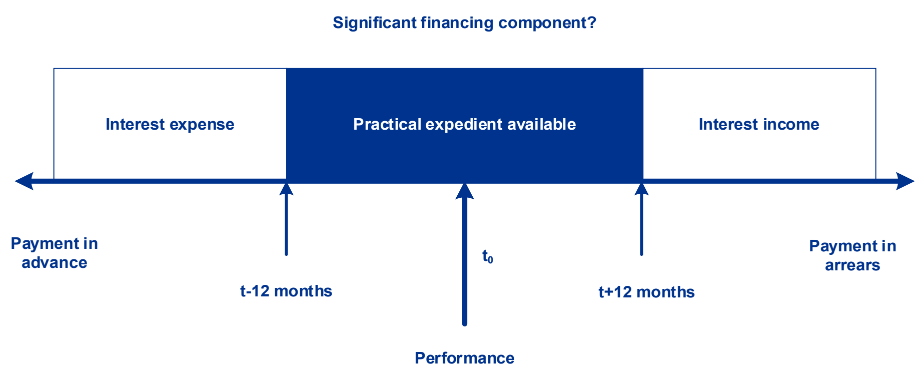
Presentation of the effects of the time value of money

An entity should present the effects of the financing component (i.e. the unwinding of the discount) separately from revenue from customers as interest income or interest expense. The unwinding of the discount should not be an element of revenue from customers because contracts with financing components that are significant to the contract have two separate economic features: one relating to the transfer of goods or services (revenue from customers) and the other relating to the financing component (interest expense or income). The Boards noted that some entities regularly enter into financing transactions and, therefore, interest represents income arising from ordinary activities for those entities. Topic 606 does not preclude an entity from presenting interest as a type of revenue in circumstances in which the interest represents income from the entity's ordinary activities.

Practical expedient to adjusting for a significant financing component

Paragraph 606-10-32-18 states that an entity is not required to make an adjustment if, at contract inception, the entity does not expect the period between payment by the customer of the consideration promised and the transfer of control of the promised good or service to the customer to exceed one year. This exception applies regardless of whether control of goods or services occurs before payment is made or payment occurs before transfer of the goods or services.

For contracts with an overall duration greater than one year, the practical expedient applies if the period between performance and payment for that performance is one year or less.



In a contract with two or more performance obligations, identifying the period between customer payment and the transfer of goods or services may present challenges, especially when the performance obligations are satisfied at different points in time and consideration is paid over time or all at once.

Illustrative examples

Illustrative Example D1

Time value of money in a single performance obligation arrangement

ABC Corp. enters into a contract to transfer a license to Software Product A to Customer for an upfront cash payment of $300,000. At contract inception, ABC expects to deliver Software Product A to Customer in two years and determines that the contract has a significant financing component. ABC's borrowing rate is 5%.

At contract inception, ABC recognizes a contract liability of $300,000 for the cash received. Over the two years, ABC recognizes interest expense and increases its contract liability by $15,000[a] in year 1 and $15,750[b] in year 2. At the end of the two-year period when it transfers control of Software Product A to Customer, ABC recognizes revenue of $330,750[c].

Notes:

a. $300,000 × 5% = $15,000.

b. ($300,000 + $15,000) × 5% = $15,750.

c. $300,000 + $15,000 + $15,750 = $330,750.

Illustrative Example D2

Time value of money in a multiple-element arrangement

ABC Corp. enters into a contract with Customer to transfer licenses to Software Product X and Software Product Y for $150,000 payable upfront. The license to Software Product X will be transferred in two years, and the license to Software Product Y will be transferred in five years.

ABC determines that the contract contains two performance obligations that are satisfied at the points in time at which the licenses are transferred to Customer. ABC allocates the $150,000 to the Software Products X and Y licenses at amounts of $37,500 and $112,500, respectively – i.e. based on their relative stand-alone selling prices. ABC concludes that the contract contains a significant financing component and that a financing rate of 6% is appropriate based on ABC's credit-standing at contract inception.

ABC accounts for the contract as follows.

Contract inception	Recognize a contract liability for the payment of $150,000
Years 1 and 2	During the two years from contract inception until the transfer of the license to Software Product X, recognize interest expense of $9,000 and $9,540[(a)] on $150,000 at 6% for Years 1 and 2, respectively, for a cumulative interest expense of $18,540
	Recognize revenue of $42,135[(b)] for the transfer of the license of Software Product X

Years 3, 4 and 5	Recognize annual interest expense of $7,584, $8,039 and $8,522[c] for Years 3, 4 and 5, respectively, based on the contract liability at the beginning of Year 3 of $126,405[d]
	Recognize revenue of $150,550[e] for the transfer of the license to Software Product Y

Notes:

a. Calculated as $150,000 × 6% for Year 1 and $159,000 × 6% for Year 2.

b. Calculated as $37,500 + $4,635, being the initial allocation to Product X license plus Product X's portion of the interest for Years 1 and 2 of the contract ($37,500 ÷ $150,000 × $18,540).

c. Calculated as $126,405(d) × 6% = $7,584; ($126,405 + $7,584) × 6%= $8,039; and ($126,405 + $7,584 + $8,039) × 6% = $8,522.

d. Calculated as $150,000 + $18,540 – $42,135, being the initial contract liability plus interest for two years less the amount derecognized from the transfer of the license to Product X.

e. Calculated as $126,405 + $24,145, being the contract liability balance after two years plus interest for three years.

Illustrative Example D3

Determining whether an arrangement has a significant financing component – Payment in advance

SaaS Company signs a three-year, non-cancellable agreement with Customer to provide SaaS. Customer may elect to either pay:

a. $140 per month (total payment is $5,040); or
b. $4,200 at the beginning of the contract term, with no additional monthly payments.

The contract includes a financing component.

The difference in pricing between option (a) and option (b), together with the timing difference between when Customer will pay the promised consideration and SaaS Company's provision of the SaaS under option (b), indicates that the contractual payment terms under option (b) have the primary purpose of providing SaaS Company with financing. The cash-selling price is the monthly fee of $140 because it reflects the amount due when the monthly hosting services are provided to Customer. A comparison of the payment terms between options (a) and (b) indicates the total cumulative interest of $840 and an implied discount rate of 13%.

SaaS Company considers if factors indicating that a significant financing component does not exist apply in this case and concludes that they do not. SaaS Company determines that the financing component is significant because the difference between the cumulative cash-selling price of $5,040 and the financed amounts of $4,200 is $840, or 20% of the financed amount. Therefore, an adjustment to reflect the time value of money will be needed if Customer elects option (b) to pay at the beginning of the contract.

SaaS Company evaluates whether the implied discount rate of 13% is consistent with the market rate of interest for companies with the same credit rating as its own. Assuming that it is, SaaS Company recognizes revenue of $5,040 ratably over the contract term as the performance obligation is satisfied and interest expense of $840 using the effective interest method. The amount of interest expense to recognize each period is based on the projected contract liability, which decreases as services are provided and increases for the accrual of interest.

Below is one example interest calculation under the effective interest method.

Period	**Contract liability – beginning of month**	**Transaction price/delivery of service**	**Interest expense at 1.083% (Monthly rate = 13% ÷ 12)**	**Contract liability – End of month**
SaaS	A	B	(A-B) × 1.083% = C	A – B + C
1	$4,200	$140	$44	$4,104
2	4,104	140	43	4,007
3	4,007	140	42	3,909
4	3,909	140	41	3,810
5	3,810	140	40	3,710
	Continue for each period…			
36	$140	$140	$0	$0

If, in the above example, the implied discount rate of 13% was determined to be an above-market rate, then the transaction price would be adjusted to reflect a market rate, based on SaaS Company's creditworthiness (i.e. because it is the party receiving the financing in this contract). The difference between the implied discount rate and the market rate would represent a discount granted to the customer for purposes other than financing; that discount would (1) reduce the amount of revenue recognized – i.e. to an amount less than $5,040 – and (2) reduce the amount of interest expense recognized by SaaS Company over the contract term (i.e. because the revenue amount is reduced, the difference between the cash paid and the revenue to be recognized, reflected as interest expense, is smaller).

Illustrative Example D4

Determining whether an arrangement has a significant financing component – Payment in arrears

ABC Corp. enters into a contract to transfer a software license to Customer priced at $2,000,000. Customer is a start-up entity with limited cash, and ABC agrees that Customer can pay for the license over two years through monthly installments of $92,000.

The contract includes a financing component. The difference in pricing between the selling price of $2,000,000 and the total of the monthly payments of $2,208,000 (24 × $92,000), together with the timing difference between when Customer will pay the promised consideration and ABC's transfer of the license, indicates that the contractual payment terms have the primary purpose of providing Customer with financing. The cash-selling price is $2,000,000 because it reflects the amount due at the point in time the license is transferred to Customer. A comparison of the cash selling price and the total payments to be received indicates the total cumulative interest of $208,000 and an implied interest rate of 9.7%.

ABC considers if factors indicating that a significant financing component does not exist are present and concludes that they do not. ABC determines that the financing component is significant because the difference between the cash-selling price of $2,000,000 and the total promised consideration of $2,208,000 is $208,000, or 10.4% of the financed amount. Therefore, an adjustment to reflect the time value of money is needed.

ABC evaluates whether the implied interest rate of 9.7% is consistent with the market rate of interest for companies with the same credit-standing as Customer. Assuming that it is, ABC recognizes revenue of $2,000,000 upon transfer of the software license – i.e. when the performance obligation is satisfied – and interest income on a monthly basis using the effective interest method. The amount of interest income for each month is based on the balance of the receivable for software license sold, which decreases as payments are received.

The following is one example interest calculation under the effective interest method.

Period	**Receivable – Beginning of month**	**Monthly payment – End of month**	**Interest income at 0.81% (Monthly rate = 9.7% ÷ 12)**	**Receivable – End of month**
SaaS	A	B	A × 0.81% = C	A – B + C
1	$2,000,000	$92,000	$16,143	$1,924,143
2	1,924,143	92,000	15,531	1,847,674
3	1,847,674	92,000	14,913	1,770,587
4	1,770,587	92,000	14,291	1,692,878
5	1,692,878	92,000	13,664	1,614,542
	Continue for each period…			
24	$91,263	$92,000	$737	$0

If, in the above example, the implied interest rate of 9.7% was determined to be a below-market rate, then the transaction price would be adjusted to reflect a market rate, based on Customer's creditworthiness. The difference between the implied interest rate and the market rate would represent a discount granted to the customer for purposes other than financing, reducing the amount of revenue recognized for the license and increasing the amount of interest income to reflect a market rate of interest.

Comparison to legacy US GAAP

Advance payments

Amounts that do not require repayment in the future, but that will instead be applied to the purchase price of the property, goods or services involved, were excluded from the requirement to impute interest under legacy US GAAP. This is because the liability – i.e. deferred revenue – is not a financial liability.

The requirements under Topic 606 when a significant financing component exists are therefore a change from legacy US GAAP because they will result in the entity recognizing more revenue than the cash received from the customer, and therefore, more revenue and more interest expense than what was recognized under legacy US GAAP for the same arrangements. This change may particularly affect software entities with contracts in which payment is received significantly before the transfer of control of goods or services – e.g. software licensing entities that bundle several years of PCS or hosting services in arrangements with payments received at the outset or in the early stages of a contract or SaaS providers that receive upfront payments in long-term SaaS arrangements (e.g. if a customer pays for a three-year SaaS arrangement in advance or pays a significant upfront fee that relates to services that will be provided over an extended period of time).

Accounting for financing components for payments in arrears may be more frequent

Under legacy US GAAP, extended payment terms could result in a conclusion that revenue was not fixed or determinable, which would preclude revenue recognition before payments became due and payable. In those cases, entities did not account for a financing element.

Under Topic 606, the transaction price is estimated and a separate evaluation is performed to determine whether the payment terms provide financing to the customer. As a result, the accounting for financing in arrangements where the customer pays in arrears will likely arise more frequently. This accounting will result in a decrease in revenue and an increase in interest income as compared to similar arrangements under legacy US GAAP; however, it also will accelerate when the decreased total amount of revenue is recognized since revenue will no longer be recognized on a 'due and payable' basis for many of these arrangements.

Question D230

Is the assessment of whether a financing component is 'significant' to a contract a quantitative or qualitative assessment?

Interpretive response: Once a financing component is determined to exist (e.g. none of the factors in paragraph 606-10-32-17 exist), it may or may not be 'significant'. And neither Topic 606, nor the basis for conclusions to any of the revenue ASUs, address explicitly how to determine whether a financing component is significant. However, discussions of the term 'material' that are included in the basis for conclusions to ASUs 2014-09 and 2016-10 state that 'material' takes both qualitative and quantitative factors into consideration – e.g. in determining whether a customer option provides the customer with a material right or whether a promised good or service is 'immaterial in the context of the contract'.

Therefore, it is, in some respects, conspicuous that 'significant' was the threshold selected for assessing financing components, indicating an intent to depart from the qualitative and quantitative nature of the term 'material'. Consequently, we believe 'significant', at least in the context of determining whether a financing component is significant, is principally a quantitative analysis.

Further, because the Boards did not provide guidance on what quantitative amounts would be significant, judgment will be required to determine at what point a financing component becomes significant to the contract.

Question D240

Does an entity need to evaluate whether there is a significant financing component in a long-term contract that transfers a software license to the customer at a point in time for which the consideration is a sales- or usage-based royalty?

Interpretive response: It depends. Paragraph 606-10-32-17(b) states that a contract with a customer does not have a significant financing component if 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* (e.g. if the consideration is a sales-based royalty).

Therefore, a significant financing component does not exist when a software license is transferred upfront, but all or a substantial portion of the consideration for that license is in the form of a sales-based royalty, or a usage-based royalty whereby the usage giving rise to the usage-based fee is dictated by third-party actions – e.g. the customer's customers' use of the platform or transaction activity – or outside events or circumstances (e.g. usage of the software depends on the occurrence of weather phenomena or changes in a stock market index).

In contrast, a usage-based fee whereby usage *is* 'within the control of the customer or the entity' would not qualify for application of the guidance in paragraph 606-10-32-17(b).

Question D250
Do extended payment terms result in a significant financing component?

Extended payment terms

Extended payment terms in software arrangements have generally been defined as those in which payment of a significant portion of the license fee is not required until more than 12 months after software delivery; however, they can include any payment terms that are elongated from the entity's customary payment terms.

Interpretive response: The existence of extended payment terms will generally lead to a conclusion that there is a financing component in the contract. Contract-specific facts and circumstances will affect whether that financing component is *significant* to the contract. However as a result of the practical expedient, entities need not consider whether extended payment terms of less than 12 months (i.e. those that are beyond an entity's customary payment terms, but less than 12 months) include a significant financing component.

If the entity expects to provide a refund or other concession to the customer as a result of the extended payment terms, the entity should account for the expected concession as outlined in Question D150.

Comparison to legacy US GAAP

See Question D150.

Question D260
What is the accounting if an entity applies the 12-month practical expedient not to account for a significant financing component but subsequently changes its expectation that customer payment and/or its performance will not occur within 12 months?

Interpretive response: Paragraph 606-10-32-18 provides that an entity is not required to make an adjustment if, *at contract inception*, the entity *does not expect* the period between payment by the customer of the consideration promised and the transfer of control of the promised good or service to the customer to exceed one year. Therefore, it is possible that the entity's expectation of payment by the customer, or transfer of control of the promised good or service, within one year may not be achieved. For example:

— A customer may prepay a software entity to customize or implement software, or to deliver a specified upgrade or enhancement. The entity may expect to complete those services or transfer the specified upgrade or enhancement in less than a year from receipt of the prepayment, but later, due to unforeseen circumstances, conclude that it will not meet that expected timeline.

— The terms of a contract may require the customer to pay for a suite of professional services only upon completion. The entity may expect to provide all of the services in less than a year, such that the customer's payment will be within one year of the performance of all services, but later concludes that it will not complete the services within one year. In that case, the customer will pay for some services performed shortly after contract inception more than one year after those services were provided.

Paragraph 606-10-32-18 is explicit to the timing of the assessment (i.e. 'at contract inception') and, unlike the guidance on collectibility (see paragraph 606-10-25-5), the remainder of the guidance on significant financing components makes no mention of reassessing the applicability of the practical expedient. Consequently, we do not believe an entity is required to reassess the applicability of the practical expedient other than if there is a contract modification that is not accounted for as a separate contract (see *Chapter G – Contract modifications*). However, we also do not believe that the guidance precludes an entity from doing so when there are significant changes in the timing of either the cash consideration or the transfer of control of goods or services in the arrangement.

The preceding paragraph notwithstanding, facts and circumstances may arise which indicate the entity's earlier conclusion that the customer payment or entity performance would meet the 12-month practical expedient was attributable to a misunderstanding of the facts and circumstances that existed at contract inception and were reasonably available to management at that time, leading to the entity inappropriately ignoring a significant financing component. In that case, the entity would have an accounting error and would need to assess the materiality of the error and any related correction to current and prior periods to determine the appropriate process for correcting the error in accordance with Topic 250, *Accounting Changes and Error Corrections*.

Question D270

Is the transaction price of a software contract with a customer with standard payment terms affected when the customer obtains financing from a third party unrelated to the software entity?

Interpretive response: No. A software entity would not have to determine whether the contract contains a significant financing component based on how its customer obtains funds to pay the fees to which the software entity is entitled under the contract.

Comparison to legacy US GAAP

Legacy US GAAP (paragraphs 985-605-55-33 through 35) concluded that a customer's use of third party financing unrelated to the software entity would not affect the software entity's revenue recognition in the arrangement, which is consistent with how we view the effect of those third-party financing arrangements under Topic 606.

Question D280

Is the transaction price of a software contract with a customer with standard (i.e. non-extended) payment terms affected where the software entity participates in the customer's financing?

Interpretive response: In circumstances where the customer of the software entity obtains external financing (i.e. not directly from the software entity), but the software entity participates in that financing (e.g. provides financial guarantees or indemnifications to the financing party, or establishes the creditworthiness of the customer to the financing party), the entity would first evaluate whether any guarantee is in the scope of Topic 460, *Guarantees* and should, therefore, be accounted for as an element of the contract outside the scope of Topic 606 (see paragraphs 606-10-15-2 and 606-10-15-4). However, if the entity's participation is in a form other than providing a guarantee to the financing party that is in the scope of Topic 460, the entity's participation creates a risk that the software entity may provide a concession either to the customer or the financing party. Questions D130 and D150 (as well as Question C90) address the issue of potential concessions, including those resulting from extended payment terms, under Topic 606.

Comparison to legacy US GAAP

Accounting for scenarios where the software entity participated in its customer's financing was more complex under legacy US GAAP than under Topic 606. Legacy US GAAP (paragraphs 985-605-55-36 and 55-37) stipulated that if the software entity's participation in the customer's financing resulted in incremental risk that the software entity would provide a refund or concession to either the end-user customer or the financing party, the presumption was that the fee was not fixed or determinable. If the software entity was unable to overcome that presumption, the software entity would recognize revenue as payments from the customer became due and payable to the financing party, provided all other requirements for revenue recognition were met. The software entity accounted for any proceeds received from the customer or the financing party before revenue recognition as a liability for deferred revenue. Therefore, a software entity had to engage in the multiple-step process of first determining whether the entity was participating in customer financing, then assessing whether that participation resulted in incremental risk that the entity would provide a refund or concession to either the customer or the financing party, and finally concluding whether it could overcome the presumption that the fees in these circumstances were not fixed or determinable.

An entity could overcome the presumption that the fees in the arrangement were not fixed or determinable if there were evidence that the software entity had a standard business practice of entering into similar arrangements with financing parties that have substantially similar provisions, and had a history of not providing refunds or concessions to the customer or the financing party (paragraphs 985-605-55-42 through 55-45).

Under Topic 606, whether a fee is fixed or determinable is not a criterion for recognizing revenue. Any risk presented by customer financing (i.e. other than that addressed by Topic 460 for guarantees within its scope) is accounted for by the variable consideration model, including the risk for refund or concession, or the guidance on identifying performance obligations (i.e. if there is a risk of providing a concession in the form of a good or service). If payments to which the entity expects to be entitled are extended, then they would be analyzed for a significant financing component. Therefore, entities may recognize revenue under Topic 606 sooner for arrangements in which the entity participates in the customer's financing and the fees were determined not to be fixed or determinable under legacy US GAAP.

Question D290

Does a prepayment in advance of scheduled payments result in a change to the transaction price for a contract that contains a significant financing component?

Interpretive response: No. The objective in Topic 606 when adjusting the transaction price for a significant financing component is for the entity to recognize revenue at an amount that reflects what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that they are transferred to the customer. Therefore, the time value of money adjustment determined at contract inception based on the stated payment terms would continue, in the event of customer prepayments in advance of contractual payment dates, to reflect the economic substance of the transaction. Topic 606 effectively presumes that the total consideration in the contract would have been less had the stated payment terms reflected an earlier payment date. The fact that the customer decided to prepay its obligation to the entity does not alter the financing component in the contract because that financing component still provided the same value to the customer.

Frequently, a customer decision to prepay the remaining scheduled payments will be accompanied by a contract modification. That modification may involve solely a change in the total amount of cash the customer will pay (i.e. a modification to the note receivable) or may involve additional changes to the performance obligations in the contract (e.g. in return for the prepayment, the customer may receive additional goods or services). In the former case, a modification to a receivable (e.g. decreasing the total cash to be paid in exchange for the prepayment) would generally follow the guidance in Topic 310, *Receivables*, applicable to creditors upon the modification or extinguishment of a customer debt instrument. In the latter case, the entity would likely have to consider both the guidance in Topic 310 and the contract modification guidance in Topic 606 (see *Chapter G – Contract modifications*).

However, if the contract is *not* modified (i.e. the terms of the contract permit customer early payment), using Illustrative Example D4, in general, the effect of a customer prepayment of scheduled amounts will be to eliminate any remaining receivable from the customer, with the difference between the balance of the receivable and the cash received recognized as some form of 'other income'. It would not be appropriate in our view to recognize additional product or service revenue from the prepayment because the customer's prepayment does not alter the financing that was provided to the customer when entering into the contract.

Comparison to legacy US GAAP

Under legacy US GAAP, in an extended payment terms scenario where the entity should only recognize revenue as the payments became due and payable, an entity would recognize revenue at the time any prepayments were received (i.e. before they were due and payable under the terms of the original contract) provided all other revenue recognition criteria were met (paragraph 985-605-55-15). In other words, a customer's prepayment would change the timing of revenue recognition from that which would have resulted from the customer paying as permitted under the contract.

In contrast, under Topic 606, customer prepayments generally will not affect the timing of revenue recognition. One possible exception to this conclusion would be if the entity is applying the alternative recognition model outlined in paragraph 606-10-25-7, which applies when there is not a contract within the scope of the revenue model, in accordance with which cash being received can directly affect the amount of revenue recognized (see *Chapter B – Step 1: Identify the contract with the customer*).

Question D300

Does a multi-year contract with annual prepayments qualify for the practical expedient?

Interpretive response: It depends. If a long-term contract (e.g. a three-year contract for SaaS, PCS or hosting services) requires the customer to pay for each year of service in advance, the contract will generally qualify for the practical expedient *provided* the prepayment relates solely to goods or services that will be provided over the year following the prepayment. This is because, in such cases, the difference between when the payment is made and transfer of the goods or services to which the payment relates is one year or less.

In contrast, if a prepayment relates to both a service to be provided over the next year following the payment *and* another service that will be provided to the customer over a longer period (e.g. a prepayment that relates to both an implementation service that will be provided over the first six months of the contract and three years of PCS), the practical expedient cannot be applied.

Question D310

Does a contract with a payment that is due more than one year before, or one year after, delivery of the related goods or services qualify for the practical expedient?

Interpretive response: No. If payment for a good or service is *due* more than one year before or one year after the transfer of the goods or services to the customer (e.g. the entity has the right to invoice the customer one year from the date the customer receives goods or services and the invoice has 30-day payment terms), the entity would not be able to apply the practical expedient because the time between the transfer of the goods or services and the expected payment date exceeds one year.

An entity is also not able to use the practical expedient if the performance obligation to which the payment relates is satisfied over time and no payments are due until more than one year after some or all of the services have been performed. For example, if professional services transferred to the customer over time will be provided over a six-month period and no payments are due until nine months after the services are completed, the practical expedient would not apply. In that case, the entity is transferring services to the customer during months one-three of the six-month service period that will not be paid for until more than one year after those services are performed.

Example D310.1

Application of the practical expedient

ABC Corp. enters into a contract with Customer to transfer a license to Software Product J and provide implementation services. Customer will pay ABC in full for the software license and the implementation services (1 million) upon transfer of the software license. The implementation services are expected to take approximately 15 months to complete. The software license and the implementation services are separate performance obligations. The software license is transferred to Customer at a point in time (see Question F20) and the implementation services performance obligation will be satisfied over time as the services are performed (see Question F180).

The practical expedient does not apply because the payment relates, in part, to services that will be provided more than 12 months after the payment from Customer is made. As discussed in Question D330, it is also not appropriate to exclude the financing effect applicable to the first 12 months of the implementation services period when either (a) determining if a significant financing component exists or (b) calculating the accounting effect of the significant financing component (if there is one) on the transaction price for the contract.

Question D320

For contracts with multiple performance obligations, how should payments be allocated to the performance obligations for purposes of determining whether a significant financing component exists or whether the practical expedient is applicable?

Interpretive response: In a contract with two or more performance obligations, identifying the period between customer payment and the transfer of goods or services may present challenges, especially when the performance obligations are satisfied at different points in time and consideration is paid over time or all at once.

In some contracts that include consideration paid over time, one performance obligation is satisfied in the early stages of a contract, while a second performance obligation continues for an extended period of time. In such cases, the entity will generally allocate each payment received to both performance obligations in the contract on a pro rata basis to calculate the financing component and determine whether the practical expedient applies. That is, allocating payments as they are made to a single performance obligation (e.g. a hardware product or software license that is the first performance obligation transferred to the customer under the contract) until it has been fully paid (i.e. a 'first-in first-out', or FIFO, allocation method) would *not* be appropriate under Topic 606. [TRG Agenda Paper No. 30]

Example D320.1

Allocation of customer payments

SaaS Provider enters into a three-year, non-cancellable SaaS arrangement with Customer. In addition to providing three years' access to its hosted application, SaaS provider will also provide various implementation services, which will be completed over a four-six months' period before 'go-live'. The SaaS and the implementation services are determined to be separate performance obligations (see Question C280), and both performance obligations are determined to be satisfied over time (see Questions F130 and F190).

In return for the SaaS and the implementation services, Customer will make three payments of $120, the first of which is due at the 'go-live' date and the remaining two payments are due on the first and second anniversaries of the go-live date. The stand-alone selling price for the three-year SaaS is $360, while the stand-alone selling price of the implementation services is $40. Therefore, the relative stand-alone selling prices for the SaaS and implementation services are $324 ([$360 ÷ $400] × $360) and $36 ([$40 ÷ $400] × $360), respectively.

SaaS Provider concludes that, in determining whether the contract contains a significant financing component and whether the practical expedient applies, the annual payments should be allocated as follows (rounded).

	SaaS	Implementation services
Payment 1 (go-live)	$108	$12
Payment 2 (1 year after go-live)	$108	$12
Payment 3 (2 year after go-live)	$108	$12

In contrast, it would *not* be appropriate to allocate the payments as follows.

	SaaS	Implementation services
Payment 1 (go-live)	$ 84	$36
Payment 2 (1 year after go-live)	$120	-
Payment 3 (2 year after go-live)	$120	-

Based on the appropriate allocation of the customer payments, the practical expedient does not apply. The implementation services will be paid for by Customer over a period of more than two years. Because there is a difference in timing between performance of the implementation services and payment for those services (i.e. the services will be provided in the first four-six months after contract inception, but will be paid for over 24 months after the completion of those services), the contract includes a financing component.

However, SaaS Provider concludes that the financing component that exists is not *significant* to the contract. This is because, if an interest element were to be calculated with respect to the implementation services based on the relative stand-alone selling price for those services and an appropriate discount rate (assume 12% reflects an appropriate discount rate considering the credit characteristics of Customer), that amount is less than $4 (i.e. only approximately 1% of the $360 total contract price), which is calculated as the difference between $36 paid in full upon completion of the implementation services and $36 paid in three equal installments after completion of the implementation services (as per the table above).

Although a financing component exists in the contract, it is not deemed to be significant to the contract and, therefore, the transaction price of the contract is not adjusted for the effect of the financing component.

Question D330

When determining whether a financing component is significant to the contract, can an entity exclude the effect of payments made within 12 months from the transfer of the related goods or services?

Interpretive response: No. Topic 606 includes a practical expedient permitting entities to ignore the effects of a financing component if the period between when the entity transfers a good or service and when the customer pays for that good or service is less than one year. Therefore, some stakeholders have suggested that entities should be able to ignore the financing effect of payments made within 12 months from the transfer of the related goods or services when determining the significance of a financing component even when additional payments for that good or service will be made more than 12 months from the transfer of that good or service.

We do not believe it is appropriate to exclude the effect of payments for goods or services that are made within 12 months from the transfer of those goods or services when additional payments for those goods or services will not be made within 12 months from their transfer. For example, if a three-year SaaS contract is entirely prepaid, it would be inappropriate to ignore any financing provided by that prepayment during the first year of the contract.

Example D330.1

Calculation of the financing component

ABC Corp. enters into a contract with Customer to transfer a three-year license to Software Product F and co-terminus technical support services and unspecified update/upgrade/enhancement rights. In return for the license and the services in this contract, Customer will make 36 monthly payments in advance of $100 each. ABC concludes that the technical support and the unspecified update/upgrade/enhancement rights are a single PCS performance obligation (see Question C150), while the software license and the PCS are separate performance obligations (see Question C170). The relative stand-alone selling prices for the software license and the PCS are $2,160 and $1,440, respectively. Consequently, each monthly payment is allocated $60 to the software license and $40 to the PCS for purposes of determining whether the practical expedient applies and whether a significant financing component exists (see Question D320). The software license is transferred to Customer at contract inception.

Because there is a difference in timing between the transfer of the license and payment for those services (i.e. the license is transferred at contract inception, but will be paid for over 36 months), the contract includes a financing component.

In calculating whether the financing component is significant to the contract, ABC imputes an interest rate of 14%. ABC calculates the significance of the financing component in the contract on the basis of an interest element of $384, calculated as the difference between the relative stand-alone selling price for the software license of $2,160 and the present value of 36 monthly payments of $60 ($1,776), which equals 10.7% of the total contract price.

It would be inappropriate for ABC to exclude the first year effect of the financing component – i.e. the difference between $720 and the present value of the first 12 monthly payments of $60 attributable to the software license from the interest element determination. In that case, the interest element would have been $340 (rather than $384), which would be 9.4% of the total contract price.

Based on the appropriate calculation, ABC concludes that the contract includes a significant financing component. Consequently, ABC recognizes $1,776 in software license revenue at the point in time it transfers control of the license to Software Product F and recognizes $384 in interest income over the 36-month term of the contract.

Question D335

Can a significant financing component exist because of a material right?

Interpretive response: Yes. When a contract contains a material right, the TRG members agreed at the March 2015 meeting that an entity needs to consider whether a significant financing component exists as a result of the material right just like any other performance obligation. [TRG Agenda Paper No. 32]

A significant financing component does not exist if a customer pays for a good or service in advance and the timing of the transfer of those goods or services is at the discretion of the customer (see paragraph 606-10-32-17(a)). In many cases, a material right will meet this exception because the customer chooses when to exercise that right. However, in some cases the customer may lack discretion and therefore the material right would not meet the exception.

Entities should also consider the practical expedient for when, at contract inception, the entity does not expect the period between payment and transfer of the promised goods or services to exceed one year (see paragraph 606-10-32-18 and Questions D300 and D310 on the practical expedient to adjusting for a significant financing component).

Question D340

Under what circumstances, if any, would an entity use a discount rate that is not entity- or customer-specific?

Interpretive response: Many companies enter into a large volume of contracts that, based on payment terms, may contain a financing component that is significant to the contract. Paragraph 606-10-10-4 provides for a practical expedient that allows entities to apply the guidance in Topic 606 to a portfolio of contracts (or performance obligations) that have similar characteristics if by doing so the entity reasonably expects the result of applying the guidance at the portfolio level would not differ materially from applying the guidance at the individual contract level.

The entity may, for example, apply a discount rate to a portfolio of contracts with similar characteristics (e.g. duration, credit quality and risk of obsolescence of underlying goods or services promised). The entity would need to ensure that new contracts are assigned to the appropriate portfolio based on common characteristics including discount rates and payment structures. An entity would be required to support that the results are not expected to be materially different from applying the guidance to the individual contract.

Question D341

Is it appropriate to use a risk-free rate as the discount rate?

Interpretive response: Generally, no. The Boards decided that using a risk-free rate would not result in useful information because the resulting interest rate would not reflect the characteristics of the parties to the contract – i.e. if the entity provides the customer financing, the entity likely would charge more for the financing when the customer's creditworthiness is lower. However, if the contract is with a customer where the risk-free rate reflects the characteristics of the parties, it could be an appropriate rate (e.g. a contract with the US government). [ASU 2014-09.BC239]

Question D342

Is using an interest rate that is explicitly specified in the contract appropriate?

Interpretive response: Not always. It may not be appropriate to use an interest rate that is explicitly specified in the contract, because the entity might offer below-market financing as a marketing incentive. Consequently, an entity applies the rate that would be used in a separate financing transaction between the entity and its customer (e.g. a financing transaction where the entity does not transfer goods or services to the customer).

This can lead to practical difficulties for entities with large volumes of customer contracts or multinational operations, because they will have to determine a specific discount rate for each customer, class of customer or geographical region of customer when a contract contains a significant financing component.

Question D343

How should an entity account for an explicitly stated interest rate it charges a customer when the contract does not include a significant financing component?

Interpretive response: Generally, we believe that charging an explicit interest rate in contracts with customers might indicate that the financing component is significant from a qualitative standpoint. In this case, an entity should consider whether the quantitative aspects outweigh the qualitative evidence when determining whether the financing component is significant.

However, it is possible for a contract that includes an explicitly stated interest rate to not include a significant financing component (see Question D230).

For such a contract, we believe it would be acceptable to recognize and present the interest component in a manner similar to when the contract has a significant financing component as interest income separate from revenue from customers. In doing so, either of the following rates could be used to determine the amount of interest income:

1. the interest rate that would be used if the contract had a significant financing component (i.e. imputed rate); or
2. the explicitly stated interest rate.

Notwithstanding the above, if the fee is more akin to variable consideration – e.g. the balance is expected to be paid over a relatively short period of time or the interest is akin to a prompt payment discount discussed in Question D160 – it may also be acceptable to include the amount in the transaction price.

Entities should apply its approach consistently to similar contracts.

Question D344

Could a contract with an implied interest rate of zero contain a financing component?

Interpretive response: Yes. When the consideration to be received for a good or service with extended payment terms is the same as the cash selling price, the implied interest rate is zero. However, a significant financing component may still exist. The difference between the promised consideration for a good or service and the cash selling price is only one factor to consider in making this determination. [TRG Agenda Paper No. 30]

For example, an entity may offer a promotional incentive that allows customers to buy items for a zero interest rate. Judgment is required to evaluate whether a financing component is present.

If the entity concludes that significant financing has been provided to the customer, then the transaction price is reduced by the implicit financing amount and interest income is accreted. The implicit financing amount is calculated using the rate that would be used in a separate financing transaction between the entity and its customer.

Noncash consideration

Excerpt from ASC 606-10

>> Noncash Consideration

32-21 To determine the **transaction price** for **contracts** in which a **customer** promises consideration in a form other than cash, an entity shall measure the estimated fair value of the noncash consideration at contract inception (that is, the date at which the criteria in paragraph 606-10-25-1 are met).

32-22 If an entity cannot reasonably estimate the fair value of the noncash consideration, the entity shall measure the consideration indirectly by reference to the **standalone selling price** of the goods or services promised to the customer (or class of customer) in exchange for the consideration.

32-23 The fair value of the noncash consideration may vary after contract inception because of the form of the consideration (for example, a change in the price of a share to which an entity is entitled to receive from a customer). Changes in the fair value of noncash consideration after contract inception that are due to the form of the consideration are not included in the transaction price. If the fair value of the noncash consideration promised by a customer varies for reasons other than the form of the consideration (for example, the exercise price of a share option changes because of the entity's performance), an entity shall apply the guidance on variable consideration in paragraphs 606-10-32-5 through 32-14. If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, an entity shall apply the guidance in paragraphs 606-10-32-5 through 32-14 on variable consideration only to the variability resulting from reasons other than the form of the consideration.

32-24 If a customer contributes goods or services (for example, materials, equipment, or labor) to facilitate an entity's fulfillment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as noncash consideration received from the customer.

> Illustrations

>> Noncash Consideration

>>> Example 31—Entitlement to Noncash Consideration

55-248 An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on January 1, 20X1, and work begins immediately. The entity concludes that the service is a single performance obligation in accordance with paragraph 606-10-25-14(b). This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

55-249 In exchange for the service, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

55-250 To determine the transaction price (and the amount of revenue to be recognized), the entity measures the estimated fair value of 5,200 shares at contract inception (that is, on January 1, 20X1). The entity measures its progress toward complete satisfaction of the performance obligation and recognizes revenue as each week of service is complete. The entity does not reflect any changes in the fair value of the 5,200 shares after contract inception in the transaction price. However, the entity assesses any related contract asset or receivable for impairment. Upon receipt of the noncash consideration, the entity would apply the guidance related to the form of the noncash consideration to determine whether and how any changes in fair value that occurred after contract inception should be recognized.

Noncash consideration received from a customer is measured at contract inception fair value. If an entity cannot make a reasonable estimate of the fair value, then it refers to the estimated selling price of the promised goods or services.

The fair value of noncash consideration can change after contract inception. Although this may be due to the occurrence or nonoccurrence of a future event, it can also vary due to the form of the consideration – e.g. variations due to changes in the price per share if the noncash consideration is an equity instrument.

When the fair value of noncash consideration varies for reasons other than the form of the consideration – e.g. the number of equity instruments to be issued by the customer to the entity – those changes are reflected in the transaction price and are subject to the guidance on constraining variable consideration. In contrast, if the variability is because of the form of the noncash consideration – e.g. changes in the stock price – then the constraint does not apply and the transaction price is not adjusted. The determination of whether a change in fair value was caused by the form of the noncash consideration or other reasons, and the determination of how to allocate fair value changes between those affecting transaction price and those that do not, may be challenging in some situations.

Noncash consideration received from the customer to facilitate an entity's fulfillment of the contract – e.g. materials or equipment – is accounted for when the entity obtains control of those contributed goods or services.

Comparison to legacy US GAAP

Exchanges of nonmonetary assets

The accounting for nonmonetary transactions based on fair value under Topic 606 is broadly consistent with legacy US GAAP on nonmonetary transactions, except for those in which the consideration received from the customer is a share-based payment.

One of the requirements for a contract to exist under Topic 606 is that it has commercial substance, which would result in nonmonetary exchanges being accounted for at fair value. Under Topic 606, if an entity cannot reasonably estimate the fair value of the noncash consideration received, then it looks to the estimated selling price of the promised goods or services.

However, under legacy US GAAP, rather than looking to the estimated selling price of the promised goods or services, the entity used the fair value of either the assets received or the assets relinquished in the exchange – unless the fair value of the assets could not be determined within reasonable limits, or the transaction lacked commercial substance (which, under Topic 606, a lack of commercial substance would mean that a contract does not exist).

Goods or services in exchange for share-based payments

Legacy US GAAP provided guidance on the measurement date for equity-based consideration received by an entity in exchange for goods or services transferred to a customer. In addition, it provided guidance on recognition and measurement when the equity-based consideration included terms that change after the measurement date as a result of achieving a performance or market condition – e.g. a change in the exercise price or term of a stock option.

Topic 606 eliminates legacy US GAAP on the accounting for share-based payments received by an entity in exchange for goods or services. Therefore, equity instruments received in a contract with a customer are accounted for consistent with other noncash consideration and measured at contract inception. When the fair value of equity-based consideration changes because of the form of consideration (i.e. changes in the value per share of stock) after the measurement date, the incremental portion of the change in fair value is not considered revenue. Changes for reasons other than the form (e.g. changes in the number of shares to be received) give rise to variable consideration, which is included in revenue in accordance with the constraint guidance.

Use of the estimated selling price

The alternative of using the estimated selling price of the promised goods or services if the fair value of the noncash consideration cannot be reasonably estimated may result in differences from practice under legacy US GAAP if an entity uses the stand-alone selling price rather than following the guidance for other fair value measurements.

In addition, Topic 606 eliminates the specific requirements on determining whether sufficient evidence exists – including prescriptive guidance requiring sufficient recent cash transactions to support the selling price – when recognizing revenue on exchanges of advertising space and exchanges involving barter credit transactions. Rather, under Topic 606, an entity recognizes revenue based on the fair value of the services received if that fair value can be reasonably estimated in a barter transaction involving advertising services. If not, the entity recognizes revenue based on the estimated stand-alone selling price of the services provided.

However, the entity will need to conclude that the contract has commercial substance – i.e. that it will change the amount, timing or uncertainty of the contract's future cash flows – in order to conclude that a contract exists. Otherwise, no revenue is recognized because the requirements for a contract under Topic 606 are not met.

Chapter A – Scope further discusses the accounting for nonmonetary exchanges of software under Topic 606 and differences in that accounting from legacy US GAAP.

Consideration payable to a customer

Excerpt from ASC 606-10

>> Consideration Payable to a Customer

32-25 Consideration payable to a customer includes:

a. Cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer).

b. Credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer).

c. Equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments).

An entity shall 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 (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13.

32-25A Equity instruments granted by an entity in conjunction with selling goods or services shall be measured and classified under Topic 718 on stock compensation. The equity instrument shall be measured at the grant date in accordance with Topic 718 (for both equity-classified and liability-classified share-based payment awards). Changes in the measurement of the equity instrument (through the application of Topic 718) after the **grant date** that are due to the form of the consideration shall not be included in the transaction price. Any changes due to the form of the consideration shall be reflected elsewhere in the grantor's income statement. See paragraphs 606-10-55-88A through 55-88B for implementation guidance on equity instruments granted as consideration payable to a customer.

32-26 If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.

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.

>> Equity Instruments Granted as Consideration Payable to a Customer

55-88A Paragraph 606-10-32-25A requires that equity instruments granted in conjunction with an entity selling goods or services be measured and classified under Topic 718 on stock compensation. If the number of equity instruments promised in a contract is variable due to a **service condition** or a **performance condition** that affects the vesting of an **award**, an entity should estimate the number of equity instruments that it will be obligated to issue to its customer and update the estimate of the number of equity instruments until the award ultimately vests in accordance with Topic 718. When measuring each instrument, the entity should include, in accordance with Topic 718, the effect of any market conditions and service or performance conditions that affect factors other than vesting. Examples of factors other than vesting are included in paragraph 718-10-30-15. Changes in the grant-date fair value of an award due to revisions in the expected outcome of a service condition or a performance condition (both those that affect vesting and those that affect factors other than vesting) are not deemed to be changes due to the form of the consideration (as described in paragraph 606-10-32-23) and, therefore, should be reflected in the transaction price.

55-88B Paragraph 606-10-32-25A requires that equity instruments granted by an entity in conjunction with selling goods or services be measured and classified under Topic 718 at the **grant date** of the instrument. When an estimate of the fair value of an equity instrument is required before the grant date in accordance with the guidance on variable consideration in paragraph 606-10-32- 7, the estimate should be based on the fair value of the award at the reporting dates that occur before the grant date. An entity should change the transaction price for the cumulative effect of measuring the fair value at each reporting period after the initial estimate until the grant date occurs. In the period in which the grant date occurs, the entity should change the transaction price for the cumulative effect of measuring the fair value at the grant date rather than the fair value previously used at any prior reporting date.

>>> Example 32—Consideration Payable to a Customer

55-252 An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores.

The customer commits to buy at least $15 million of products during the year. The contract also requires the entity to make a nonrefundable payment of $1.5 million to the customer at the inception of the contract. The $1.5 million payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products.

55-253 The entity considers the guidance in paragraphs 606-10-32-25 through 32-27 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 606-10-32-25, the $1.5 million payment is a reduction of the transaction price.

55-254 The entity applies the guidance in paragraph 606-10-32-27 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognizes revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10 percent ($1.5 million ÷ $15 million). Therefore, in the first month in which the entity transfers goods to the customer, the entity recognizes revenue of $1.8 million ($2.0 million invoiced amount – $0.2 million of consideration payable to the customer).

Payments to a customer may relate to goods or services received from the customer, a discount or refund for the goods or services provided to the customer, or a combination of both. As such, the entity needs to evaluate the substance of the payment.

Consideration payable to a customer includes cash amounts that an entity pays or expects to pay to the customer. It also includes credits or other items (e.g. a coupon or voucher) that can be applied by the customer against the amount owed to the entity or to other parties that purchase the entity's goods or services from the customer. [606-10-32-25]

Entities will also need to evaluate payments made to other parties in the direct chain of distribution. This is because payments to customers include cash payments that an entity pays, or expects to pay, to the customer or to other parties that purchase the entity's goods or services from the customer. However, in some cases an entity may conclude that it is appropriate to apply the guidance more broadly to payments made to entities outside the direct distribution chain. [606-10-32-25]

Question D345

Are payments outside the contract with the customer or direct distribution chain evaluated as consideration payable to a customer?

Interpretive response: It depends. Determining how broadly to evaluate payments within and outside a distribution chain is a matter of judgment.

Payments made to a customer that are not specified in the contract may still represent consideration payable to a customer. An entity develops a process for evaluating whether any other payments made to a customer are consideration payable that requires further evaluation under Topic 606. However, an entity need not always identify and assess all amounts ever paid to a customer to determine if they represent consideration payable to a customer. [TRG Agenda Paper No. 28]

Payments within the direct distribution chain – i.e. payments to other parties that purchase the entity's goods or services from the customer – are accounted for as consideration payable to a customer. However, the evaluation of payments to parties outside a direct distribution chain requires judgment and a determination as to whether those incentives represent payments on behalf of the entity's customer. The consideration payable to a customer guidance may apply to these payments in some circumstances.

For example, an entity may have transactions or a business model that results in payments to a customer's customer who is not in the direct distribution chain because that party does not purchase the entity's goods or services. This is common in arrangements in which the entity is an agent connecting its customer to the end user of the customer's goods or services – e.g. a platform or marketing company that connects buyers and sellers may provide incentives to the buyer to increase the buyer's purchases with the seller. Depending on the facts and circumstances, the platform or marketing company may conclude either the buyer or the seller or both are the entity's customers. In these types of business models, the analysis of whether to apply the consideration payable to a customer guidance begins with the entity's conclusion about whether it has more than one customer among the various parties. [TRG Agenda Paper No. 28]

However, even when an entity concludes that the party to which it makes incentive payments is not its customer and is not within the direct distribution chain, the entity still evaluates those payments to determine whether they represent payments made on behalf of the entity's customer and, if so, the consideration payable to a customer guidance is applied. [TRG Agenda Paper No. 28]

This evaluation considers not only contractual obligations to the customer but also any implied promises to provide incentives to the entity's customer's customer. We understand that the SEC staff believes, in general, that an implied promise for an entity to make payments (i.e. fund discounts) to buyers (i.e. end users) that purchase from the entity's customers exists if the entity's incentive promotion or program is reasonably knowable to the entity's customers. Based on discussions with the SEC staff, an incentive promotion or program may be reasonably knowable to a customer when the benefit is visible to the customer (e.g. via a platform app, website, e-mails, or other forms of communications that are accessible by the customer) such that the customer is reasonably aware that end users of the entity's platform are receiving benefits on purchases and therefore has a reasonable expectation that incentives will be provided to the entity's customer. See Example D345.1.

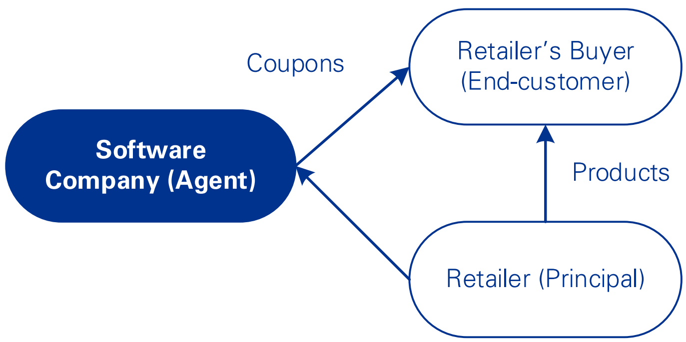
An entity may also make payments to a third party outside the distribution chain on behalf of a customer. The consideration payable to a customer guidance may also apply to these payments in some circumstances (see Question D346).

Example D345.1

Payments to customers – payments outside the distribution chain

Software Company (agent) markets and incentivizes the purchase of Retailer's (principal) computers by providing coupons to Retailer's Buyer (end customer). Software Company's software is embedded in the Retailer's computer, and Software Company earns revenue from Retailer when computers are purchased by Retailer's Buyer with the embedded software.

The following diagram depicts this arrangement.



Depending on the facts and circumstances, Software Company might conclude that:

- both Retailer and Buyer are its customers. In that case, Software Company applies the consideration payable to a customer guidance to determine whether the coupon payment is accounted for as a reduction of revenue or as an expense if it is payment for a distinct good or service; or
- only Retailer is its customer. In that case, Software Company performs an additional evaluation to determine whether the coupon payment represents the fulfillment of a promise (contractual or implied) to the Retailer to provide coupons to its customer (i.e. a payment made to Retailer's Buyer on behalf of the Retailer customer). If a contractual obligation or an implied promise exists, the payments are accounted for as a reduction of revenue. If no contractual or implied promise to the Retailer exists, then the coupon payment is generally recorded as sales and marketing expense.

See Question D345 for additional considerations when the entity is making a payment to a third party that is its customer's customer.

Question D346

Are payments to a third party evaluated as consideration payable to a customer?

Interpretive response: Yes, in some cases. While incentives are often paid directly to a customer or a customer's customer, there are cases in which payments are made to a third party outside the direct chain of distribution. For example, an entity may agree to make a payment directly to a third-party vendor on the customer's behalf.

Determining if such a payment is consideration payable to a customer requires an evaluation of the nature of the payment. We believe the direction of the cash payment by the entity (i.e. whether directly to the customer or to a third party) should not, on its own, drive the accounting conclusion. Instead, an entity considers whether the payment is, in substance, an incentive to the customer under the contract. Incentive payments could occur before or after an entity enters into a contract with the customer.

An entity needs to develop a process for evaluating whether payments made to third parties represent consideration payable to a customer. An entity also needs to consider whether it obtains control of a distinct good or service from the third party.

The payment to a third party is evaluated as consideration payable to a customer and recognized as a reduction to revenue when:

— the entity does not obtain control of a distinct good or service provided by the third party; and
— the payment to the third party is for the customer's benefit.

Conversely, if the entity obtains control over a distinct good or service from the third party, it accounts for the payment in the same way as other purchases. If that good or service is subsequently transferred to the customer, it represents the satisfaction of a performance obligation under the contract.

See Question D345 for additional considerations when the entity is making a payment to a third party that is its customer's customer.

Example D346.1
Customer incentive paid to a third party

ABC Corp. enters into a contract with Customer to provide SaaS over 5 years. The contract entitles Customer to a specified hardware component to be used with ABC's SaaS. The hardware is paid for by ABC as an incentive for Customer to enter into the arrangement. ABC has a relationship with a hardware supplier through which it can obtain substantial price discounts.

Scenario 1: ABC does not obtain control of the goods

ABC places the hardware order with the agreed-upon supplier directly. Customer can select the style of the hardware and designate the location to which they will be shipped. ABC does not take possession of the hardware. ABC subsequently makes a payment directly to the supplier to settle the purchase.

The nature of this payment to the supplier is, in substance, an incentive for Customer to enter into the arrangement. ABC does not receive a distinct good or service from the supplier because at no point does ABC control the hardware or direct its use. Therefore, the payment is accounted for as consideration payable to a customer and a reduction of the transaction price in the contract with Customer. Because the SaaS transfers over time (see Question F130), the payment reduces revenue over the term of the service based on an appropriate measure of progress.

Scenario 2: ABC obtains control of the goods

ABC makes bulk hardware purchases and separately provides them to customers when a new contract is entered into and also sells hardware separately. ABC takes possession of the hardware and bears the risk of loss until it is delivered to Customer.

In this scenario, ABC receives a distinct good or service in exchange for the payment to the supplier. While the purpose of the hardware is to incentivize Customer to enter into a new arrangement, ABC determines that it has control over the hardware and can direct its use for other purposes as it chooses. For example, it could choose to resell the hardware to any customer. Therefore, procurement of the hardware from the supplier is accounted for as a purchase rather than consideration payable to a customer.

The hardware is determined to be distinct from the SaaS. Therefore, when the hardware is controlled by ABC before it is transferred to Customer, it is accounted for as performance obligations in the contract.

Example D346.2
Commission paid to a third party

ABC Corp. provides its customers with access to its proprietary online database of resumes, which customers use to fill personnel positions. Most customers enter into an arrangement directly with ABC for access to its online database. However, certain customers (Customers) are referred to ABC through a recruitment agency (Agency) that assists Customers with their larger recruitment efforts. Agency provides Customers with a suite of services and also suggests that Customers use ABC's platform as a tool to identify qualified candidates.

ABC has an arrangement with Agency that obligates ABC to pay Agency a commission when Customers sign up for access to ABC’s database. Agency does not commit to a quantity of referrals but when Customers want to purchase access to ABC’s database, Agency collects the full list price of ABC’s services from Customers and remits the amount due to ABC net of their commission.

ABC considers the following facts when determining how to present the amounts retained by Agency:

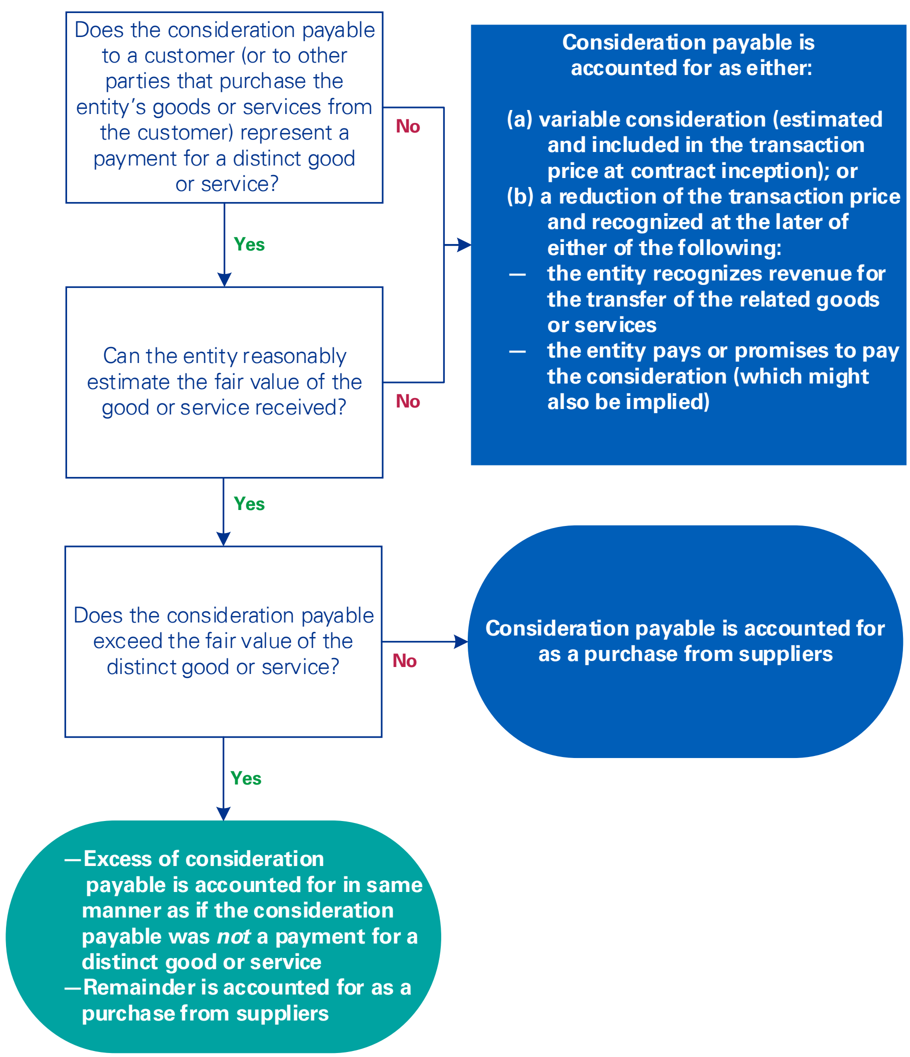
- The contracts between Agency and Customers typically empower Agency to act on behalf of Customers when they choose to use ABC’s services. Agency will often execute the contracts with ABC on Customers’ behalf.
- The licenses to access ABC’s database are in the Customers’ name and not the Agency’s name. Likewise, order forms and invoices are in the names of Customers (not Agency), but reference the right of the end-customers to have their enrolled agent execute or fulfill on their behalf.

— Agency does not control the license to access ABC's database before it is provided to Customers and Customers can cancel their arrangement with Agency without affecting their ability to use and benefit from ABC's database.

Agency is performing a service for both ABC and Customers under separate arrangements. Agency is not a reseller of ABC's database but rather acts in the capacity of a sales agent for ABC. The nature of the payments made to Agency is commissions to obtain contracts with customers. Although the amounts collected from Customers are net of the commission payments when remitted by Agency, the commission payments do not represent payments to a customer and are therefore presented as costs to obtain a contract and do not reduce revenue.

Accounting for consideration payable to a customer

The following decision tree summarizes how an entity would distinguish between a reduction of transaction price or a payment for goods or services.



Payments for a distinct good or service

When a payment to a customer is for a distinct good or service, an entity accounts for the payment in the same way as for other purchases from suppliers. An entity evaluates whether a good or service received from the customer is distinct using the same criteria in Step 2 to identify performance obligations. See *Chapter C: Step 2* for further discussion of the distinct criteria. [606-10-32-26]

If the entity does not receive a distinct good or service in exchange for the payment, the payment is considered a reduction of the transaction price.

Fair value of the payment

The amount of consideration received from a customer for goods or services and the amount of consideration paid to that customer for goods or services could be linked even if they are separate events. For example, a customer may pay more for goods or services from an entity than it otherwise would have paid if it were receiving a payment from the entity. [606-10-32-26]

As such, any amount paid to a customer for goods or services is limited to their fair value. The amounts in excess of fair value are recorded as a reduction of the transaction price. [606-10-32-26]

If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it accounts for all of the consideration payable to the customer as a reduction of the transaction price. [606-10-32-26]

Payment accounted for as a reduction of the transaction price

Consideration payable to a customer that is a reduction of the transaction price is either accounted for as variable consideration and included in the transaction price at contract inception or subject to the 'later of' guidance. [606-10-32-25, 32-27]

If the consideration payable to a customer includes a variable amount, it estimates the amount at contract inception and includes that amount in the transaction price. The transaction price is recognized as revenue when (or as) control of the goods or services is transferred. [606-10-32-25]

However, if the amounts are subject to the 'later of' guidance, the payments are recognized as a reduction of revenue as the later of the date when the related revenue is recognized or the entity promises to pay such considerations (which can be implied). [606-10-32-27]

As a result, because the accounting could be different, the entity will need to distinguish between when the payments are accounted for as variable consideration or under the 'later of' guidance

Comparison to legacy US GAAP

Rebuttable presumption eliminated

Under legacy US GAAP, cash payments made from an entity to a customer were presumed to be a reduction of revenue. This presumption could be overcome if the entity received an identifiable benefit in exchange for the cash payment and the fair value of the benefit could be reasonably estimated. [605-50-45-2]

Topic 606 requires an entity to evaluate whether it receives distinct goods or services in exchange for its payment to a customer, instead of whether the entity has received an identifiable benefit. Although these concepts appear to be similar, Topic 606 does not contain the rebuttable presumption that the payment is a reduction of revenue.

Question D347

Does an entity include variable consideration in the transaction price or follow the 'later of' guidance on consideration payable to a customer?

Interpretive response: It depends. Amounts payable to a customer could be both variable consideration and consideration payable to a customer. However, the accounting for variable consideration and consideration payable to a customer could be different.

— **Variable consideration.** The entity estimates the variable consideration at contract inception and this estimate affects the transaction price. The transaction price is recognized as revenue as control of the goods or services is transferred.

— **Consideration payable to a customer ('later of' guidance).** Amounts are recognized as a reduction of revenue at the *later of* when the related revenue is recognized or the entity promises to pay such considerations (which can be implied).

To determine whether to account for the payment as variable consideration or follow the 'later of' guidance, an entity evaluates its past practice and other activities that could give rise to an expectation at contract inception that the transaction price includes a variable amount. For example, in the case of a customer incentive, at contract inception an entity evaluates whether it intends to provide an incentive or if the customer has a reasonable expectation that an incentive will be provided even though it may be in the form of consideration payable to a customer. If yes, then the incentive constitutes variable consideration. The incentive reduces the transaction price and revenue will be affected when the entity transfers control of the good or service.

The 'later of' guidance applies only if the entity concludes at contract inception that the contract does not have variable consideration in the form of an incentive to the customer or if the contract at inception includes a fixed payment to a customer. An example of a fixed payment is a nonrefundable upfront payment to a customer (see Question D370).

Example D347.1

Payments to customers – Variable consideration

Software Company C contracts with Retailer X and delivers shrink-wrapped software on December 15, Year 1. On January 20, Year 2, Software Company C offers coupons in a newspaper to encourage retail sales of the software sold to Retailer X. Software Company C agrees to reimburse Retailer X for coupons redeemed. Software Company C offered similar coupons in prior years.

Software Company C would likely determine that the transaction price for the goods sold on December 15, Year 1 included variable consideration, given its history of offering coupons.

Conversely, if Software Company C had not offered coupons in prior years and did not expect to offer any coupons at contract inception, then it would recognize the amount payable to the retailer as an adjustment to revenue when it communicated to Retailer X its intention to reimburse Retailer X for any redeemed coupons.

Question D350#

Are payments to customers in the form of equity-based instruments, instead of cash, considered 'consideration payable to a customer'?

Interpretive response: Yes. Topic 606 states that consideration payable to a customer includes equity-based instruments (liability- or equity-classified) granted to customers in conjunction with selling goods or services. Therefore, these instruments are recognized as a reduction of revenue unless they represent a fair value payment for a distinct good or service under Topic 606.

When the equity-based instruments are accounted for as a reduction of revenue, the grant date fair value is recognized as a reduction of revenue in the same manner as if the entity made a cash payment to the customer. However, Topic 606 states that the equity-based instruments are measured and classified under Topic 718 (share-based payments). Therefore, it is important to consider the applicable guidance in both Topic 718 and Topic 606 for these transactions.

The following are some of the key aspects to consider when evaluating an equity-based instrument issued to a customer accounted for as a reduction of revenue.

Grant date fair value

The grant-date fair value of an equity-based instrument (as determined under Topic 718) is ultimately recorded as a reduction of revenue. However, if an entity promises or intends to provide an equity-based instrument to a customer and the grant date has not occurred, the entity follows the transaction price guidance in Topic 606 and estimates the fair value of the equity-based instrument. The estimate of fair value is adjusted each reporting date until the grant date(s) is achieved. See section 4 of KPMG Handbook, Share-based payment, for further discussion on determining the grant date.

Fully vested shares

If the equity-based instruments are fully vested (e.g. not subject to future customer purchases), the entity evaluates the payment in the same way it would a cash incentive payment to determine when and how to record it. This evaluation may be similar to the accounting for nonrefundable upfront cash payments to a customer as discussed in Question D370 and require the entity to assess whether to recognize an asset. Therefore, depending on the facts and circumstances, even though the equity-based instruments are immediately vested they may not be immediately recognized as a reduction of revenue but instead recorded as an asset and recognized as a reduction of revenue as future revenue is recognized. See chapter 5 of KPMG Handbook, Revenue recognition, for further discussion on upfront payments to customers.

Vesting conditions

An entity may grant equity-based instruments to the customer with vesting conditions. When the vesting is based on a service condition or performance condition, the amount that ultimately is recorded as a reduction of revenue depends on the number of shares that actually vest according to those conditions. Each reporting date, the transaction price is reduced by the grant-date fair value of the number of equity-based instruments expected to vest (subject to the entity's forfeiture policy discussed below) in accordance with Topic 718. The amounts are adjusted each period until the equity-based instrument ultimately vests.

When vesting is based on a market condition (e.g. the entity achieving a target share price), the existence of that condition affects the grant-date fair value of the award and not whether it is recorded. Therefore, the existence of a market condition does not change the number of equity-based instruments that are recorded as a reduction of revenue but rather the grant-date fair value of those equity-based instruments.

Judgment is required to evaluate and distinguish between different types of vesting conditions. See section 4 of KPMG Handbook, Share-based payment, for further discussion on vesting conditions. The following are additional considerations related to service and performance conditions.

Service condition

A service condition includes nonemployees rendering services to the grantor. We believe it also includes vesting based on a customer purchasing a volume of goods or services.

Determining the number of equity-based instruments with a service condition that are expected to vest depends on the entity's policy election for estimating forfeitures.

- If an entity's policy is to estimate expected forfeitures, it reduces the transaction price by the number of equity-based instruments that are expected to vest and adjusts that estimate each reporting date.
- If an entity's policy is to record forfeitures only when they occur, it reduces the transaction price for the full number of equity-based instruments that could vest regardless of probability and would only increase the transaction price if the equity-based instruments are forfeited.

An entity's forfeiture policy is an entity-wide accounting policy election that applies to all nonemployee equity-based instrument transactions, including arrangements with customers. Entities should carefully evaluate their policy decision because the timing and amount of revenue recognized may significantly differ, may not align with the economics of the transaction and may differ from a cash incentive. See section 4 of KPMG Handbook, Share-based payment, for a discussion of the entity's forfeiture policy for nonemployee awards.

Performance condition

A performance condition includes achieving a target solely based on the grantor's own operations (or activities) or the grantee's performance related to the grantor's own operations (or activities). Examples of a performance condition include equity-based instruments that vest upon a grantor's liquidity event (e.g. change of control or IPO) or the grantor achieving a specified milestone (e.g. FDA approval) or level of profitability.

Equity-based instruments granted to a customer with a performance condition are only estimated and included as a reduction in the transaction price when the performance condition is probable of being achieved. While assessing the probability of service or performance condition vesting is similar to estimating variable consideration under Topic 606 (subject to the constraint), the variability in revenue associated with vesting conditions is measured under Topic 718.

Classification

An equity-based instrument issued to customers is equity-classified or liability-classified in accordance with Topic 718. An equity-classified award is measured at grant-date fair value and is not remeasured. A liability-classified award is measured at grant-date fair value and then remeasured each period. Nonpublic entities can make a policy election to measure all liability-classified instruments in Topic 718 either at fair value or at intrinsic value. See section 3 of KPMG Handbook, Share-based payment, for a discussion on determining classification.

For both equity-classified and liability-classified instruments granted to customers, the grant-date fair value is ultimately what is recorded as a reduction of revenue. The subsequent remeasurement of the liability is recorded elsewhere in the entity's income statement.

Modifications

If an entity modifies the equity-based instrument granted to a customer and that modification changes the fair value, vesting conditions or classification of the equity-based instrument, it evaluates the modification under Topic 718, which could impact the value that is recorded as a reduction of revenue. Additionally, the entity needs to evaluate the impact of the modification under Topic 606 to determine how any changes resulting from the modification are recorded as a reduction of revenue.

Assessing modifications can be complex under both Topic 718 and Topic 606. See section 5 of KPMG Handbook, Share-based payment, for a discussion of modifications under Topic 718. See chapter 11 and chapter 5 of KPMG Handbook, Revenue recognition, for guidance on modifications under Topic 606 and illustrative example of payments to customers in the form of equity-based instruments, respectively.

Question D360

How should an entity present consideration payable to a customer that results in 'negative revenue'?

Interpretive response: Unless a payment to a customer is in exchange for a distinct good or service, an entity accounts for the payment as a reduction of the transaction price and, therefore, of revenue. In some situations, the amount of consideration payable to a customer could exceed the cumulative amount of consideration the entity expects or has received from a customer resulting in 'negative revenue'. Topic 606 does not explicitly address whether it is appropriate to reclassify negative revenue to expense. [606-10-32-25]

We believe an entity will typically record consideration payable to a customer as a reduction of revenue even when it results in negative revenue. However, there may be limited circumstances in which reclassifying negative revenue to an expense is also acceptable. The following are examples in which recognizing an expense would be acceptable.

— An entity makes an upfront payment to a potential new customer in relation to a new product. However, the entity cannot conclude that the payment represents an asset related to expected purchases because there is no committed contract and a high degree of uncertainty of obtaining future contracts.

— A customer relationship is terminated such that it is unlikely that there will be future anticipated contracts, and the payment exceeds cumulative revenue recognized during the customer relationship, possibly because of threatened litigation.

There may be other limited circumstances in which there is negative revenue in a period, and determining whether it is appropriate to reclassify the payments to expense will require significant judgment based on an evaluation of the facts and circumstances.

Question D370

How should an entity account for a nonrefundable upfront payment to a customer or potential customer?

Interpretive response: It depends. Entities may make nonrefundable upfront payments to customers or potential customers to motivate that (potential) customer to enter into a contract. Often these are characterized as 'pay to play' or 'exclusivity' payments, but they can also be made to reimburse the customer for costs associated with entering into the contract – new vendor costs, termination fees on previous contract, etc.

When the upfront payments are not in exchange for a distinct good or service, entities account for the cost as a reduction of the transaction price. However, many times entities may make these payments even if there is no enforceable contract with the customer or the contract term is very short (e.g. a month-to-month contract). In those scenarios, recognizing an upfront payment immediately as a reduction of revenue or as an expense could result in an upfront loss.

The TRG discussed two potential approaches to accounting for nonrefundable upfront payments to customers. [TRG Agenda Paper No. 59]

View A: Expected purchases	Payments to customers are capitalized and amortized as a reduction of revenue over expected purchases, including purchases under potential future contracts.
View B: Contract period	Payments to customers are recognized as a reduction of revenue over the existing contract. If no contract exists, the payment is immediately recognized in the income statement.

The TRG agreed that View A is appropriate when the payment meets the definition of an asset and is recoverable from future cash flows (including cash flows from anticipated renewals or contracts). View B would only be appropriate when the payment only relates to the existing contract. [TRG Agenda Paper No. 59]

In addition, Ruth Uejio, Professional Accounting Fellow, Office of Chief Accountant, discussed this topic in a speech given during the 2016 AICPA National Conference on Current SEC and PCAOB Developments.

> "From my perspective, a company must first determine what the payment was made for. The following are some of the questions that OCA staff may focus on to understand the nature and substance of the payment:
>
> 1. What are the underlying economic reasons for the transaction? Why is the payment being made?
> 2. How did the company communicate and describe the nature of the payment to its investors?
> 3. What do the relevant contracts governing the payment stipulate? Does the payment secure an exclusive relationship between the parties? Does the payment result in the customer committing to make a minimum level of purchases from the vendor?
> 4. What is the accounting basis for recognizing an asset, or recognizing an upfront payment immediately through earnings?
>
> Once a company has determined the substance of the payment, I believe a company should account for the payment using an accounting model that is consistent with the identified substance of the payment and relevant accounting literature. Additionally, companies should establish accounting policies that are consistently applied. I'd highlight that there should be a neutral starting point in the accounting evaluation for these types of arrangements. I believe that registrants must carefully evaluate all of the facts and circumstances in arriving at sound judgments, and should perform the analysis impartially. Additionally, in my view 'matching' is not a determinative factor to support asset recognition." [2016 AICPA Conf]

Concepts Statement 6 defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." As such, based on the SEC speech, the TRG discussion, the definition of an asset and framework in Subtopic 340-40, we believe the following are factors (not exhaustive) that may indicate that View A is appropriate.

1. **The payment is recoverable through the initial contract and/or future anticipated renewals.** To meet the definition of an asset, the entity must be able to recover the asset through future cash flows. Further, the entity needs to obtain or control those particular benefits. By entering into the initial contract, the entity obtained the control of an asset. However, in some instances the entity may only expect to recover the payment through future anticipated contracts. If the payment relates to initial and future anticipated contracts, the asset could be recoverable through cash flows related to both. While payments to customers are not in the scope of Subtopic 340-40, this concept is similar to the notion underlying costs to obtain contracts with customers. As such, we believe entities could look to both the initial and future anticipated renewals to assess the recoverability of the asset.
2. **The entity secures an exclusivity agreement and it is probable that the customer will make purchases sufficient to recover the payment.** If the payment secures an exclusive relationship between the entity and its customer and it is probable the customer will order a sufficient number of goods or services to recover the payment, the payment would meet the definition of an asset as the entity has obtained a right that it controls and would benefit from that relationship.
3. **History of renewals/average customer life.** If the entity has a history or renewals with similarly situated customers, an average customer life longer than the initial contract term might indicate the payment relates to future expected renewals. Unless, as noted in (1) below, the payment relates only to the current contract.
4. **Underlying reason for the payment.** An entity should also consider its customary business practices and reason for making the payment. If the payment is a one-time expenditure at the beginning of a new contract (new customer, new product line, etc.) to secure a relationship, that payment may meet the definition of an asset because the payment obtained the contract with the customer.

In contrast, we believe the following may indicate that View B is appropriate:

1. **The payments are recurring and commensurate with the subsequent payments upon renewal.** If the entity makes payments at the beginning of each contract and subsequent renewal, it would indicate that the payment relates only to the current contract.
2. **The entity does not obtain any contractual assurance (e.g. exclusivity or a customer contract) that future contracts will be obtained.** If the entity does not obtain any contract (even if short-term) or exclusivity agreement, the entity may not have an asset that it controls.
3. **The entity is entering into a new market or selling new products or services.** If the entity does not have a history to suggest that it will be successful in recovering the payment through the current or future anticipated contracts, it may be inappropriate to defer and amortize the payment longer than the current contract.

See Questions D390 and D400 for a discussion of the amortization period and impairment model for these assets.

Example D370.1

Nonrefundable upfront payment to a customer – SaaS

SaaS Corp. agrees to make a $1 million nonrefundable upfront payment to Customer to help offset transition costs for a SaaS contract. The contract term is five years but is cancellable each month without penalty. Therefore, the contract term is only one month under Topic 606 (see Question B130). SaaS Corp. expects the customer to purchase services for the full five years with estimated fees of $6 million based on its experience with similar customers and its customary business practice of making similar payments. SaaS Corp. expects to earn margins of at least 25%.

To determine the appropriate accounting, SaaS Corp. performs the following evaluation.

- **The payment is recoverable through the cash flows from the initial contract and anticipated future renewals.** The payment is expected to be recoverable from future net cash flows totaling $1.5 million ($6 million × 25% profit margin).
- **History of renewals/average customer life.** SaaS Corp. expects a customer life beyond the initial five-year term based on its history with similar customers and making similar payments.
- **Underlying reason for the payment.** The purpose of the payment is to incentivize Customer to enter into the contract and use SaaS Corp. for a number of years. SaaS Corp. has a customary business practice of making these payments at the beginning of a new customer relationship and does not generally make additional payments when the customer renews the contract.

Based on its overall evaluation of these factors, SaaS Corp. concludes that the payment should be capitalized and amortized as a reduction of revenue over the anticipated future purchases (see Question D390).

Example D370.2

Nonrefundable upfront payment to a customer – New product

ABC Corp. has recently launched a new product in a developing field with a high risk of technological obsolescence. In order to incentivize Reseller to buy and sell this product to its end customers, ABC makes a $1 million nonrefundable upfront payment to enter into an MSA that sets the pricing of future product purchases. Reseller does not agree to exclusively sell ABC's products or commit to a minimum quantity.

Reseller requires this payment to cover the cost of attempting to sell the product to its end customers if it is not successful in the market. Given that this is a new product, ABC does not have historical experience with this product or similar customers.

ABC considers the following to evaluate the accounting for the payment to Reseller.

- **The entity secures an exclusivity agreement and it is probable that the customer will make purchases in order to recover the payment.** ABC did not obtain a contract for a minimum purchase or exclusivity agreement from Reseller. While the MSA is a legal contract, Reseller did not commit to a minimum quantity.
- **History of renewals/average customer life.** The payment could be viewed as obtaining a customer relationship; however, the lack of historical experience and risk of obsolescence indicate that the payment may not be recoverable through future purchases.
- **Underlying economic reason for the payment.** ABC made the payment to Reseller in order to get its product into the market. However, due to the uncertainty and experience related to the product, it is uncertain whether the payment will be recoverable.

Based on its overall evaluation of the factors, ABC concludes that this payment does not represent an asset. Therefore, it accounts for the payment as a reduction of revenue (or expense) when the payment is made.

Question D380

Are upfront payments to customers that are capitalized classified as a contract asset?

Interpretive response: Generally, no. When an entity makes an upfront payment to a customer and does not receive distinct goods or services in exchange for the payment, the payment generally reduces the transaction price and is recognized either over the current contract term or estimated future purchases (see Question D370). If the payment is deferred and recognized over a future period, the entity records an asset.

This asset typically does not meet the definition of a contract asset. Contract assets are rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time. When an entity makes an upfront payment to a customer, it has not yet transferred goods or services, which is why the asset created by the upfront payment does not meet the definition of a contract asset. As a consequence, the asset would not be presented with contract assets and would be presented separately in other assets or another appropriate financial statement line item.

However, we believe it is also acceptable to present an asset created by a payment to a customer that reduces the transaction price as a contract asset (or net contract liability) when the asset relates only to the current contract – i.e. the amortization period does not include future contracts. This is because a contract asset or contract liability reflects the relationship between the entity's performance and the customer's payments for a current contract. In other words, when the payment reduces the transaction price, it could be viewed similar to consideration received from the customer and therefore included in the net position of the contract.

It would not be appropriate to reflect an asset that relates to multiple contracts as a contract asset because the unit of account for a contract asset and contract liability is a single contract with a customer.

For a discussion of the amortization and impairment of assets resulting from payments to customers, see Questions D390 and D400.

Question D390

What is the amortization period for a nonrefundable upfront payment capitalized as an asset?

Interpretive response: The TRG agreed that the assessment of the amortization period should be based on an evaluation of expected cash flows from a customer and an entity could make this determination in the same way it does for other assets. For example, the guidance for determining the useful life of intangible assets in Subtopic 350-30 or determining the useful life of a cost to obtain a contract with a customer in Subtopic 340-40 could be useful as a framework for determining the amortization period. [TRG Agenda Paper No. 59]

We believe multiple approaches may be acceptable as long as they consider the period of expected cash flows from the customer contracts to which the payment relates. However, we believe the most relevant analogy is the guidance in Subtopic 340-40, because the payments to a customer are typically akin to a cost of obtaining a contract. As a result, the amortization period could include both the current and anticipated contract renewals. See *Chapter H – Contract costs* for further details on determining the amortization period in Subtopic 340-40.

Question D400

How should an entity test a nonrefundable upfront payment that has been deferred for impairment?

Interpretive response: The TRG agreed that in the absence of explicit guidance, applying the principles behind other impairment tests in US GAAP would be a supportable approach to testing a capitalized upfront fee for impairment. In general, we believe multiple approaches may be acceptable as long as they only take into account the recoverability of the asset from contracts with the customer to which the payment relates. [TRG Agenda Paper No. 59]

We believe the most relevant analogy would be for an entity to use the impairment model in Subtopic 340-40 related to costs capitalized for obtaining contracts with customers. That impairment model takes into account cash flows from both current and future anticipated contracts to which the asset relates. Under that guidance, an impairment loss is recognized for the difference between the carrying amount of the asset and:

— consideration (in exchange for the goods or services to which the asset relates) expected to be received in the future or received but not yet recognized as revenue, less
— the costs that relate directly to providing those goods or services and that have not been recognized as expenses. [340-40-35-3]

However, the TRG did not include the contract asset impairment model as a potential alternative. Paragraph 606-10-45-3 states that an impairment of a contract asset should be measured, presented and disclosed in accordance with Topic 310 (or Subtopic 326-20 on adoption). We do not believe Topic 310 (or Subtopic 326-20) would be an appropriate model for this asset because there is no credit risk involved with the payment to a customer.

For guidance on and interpretation of Subtopic 326-20, see KPMG Handbook, Credit impairment. See *Chapter H – Contract costs* for further details on the impairment testing in Subtopic 340-40.

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

Questions and Examples

New item added to this chapter: **
Item significantly updated in this edition: #

Overview

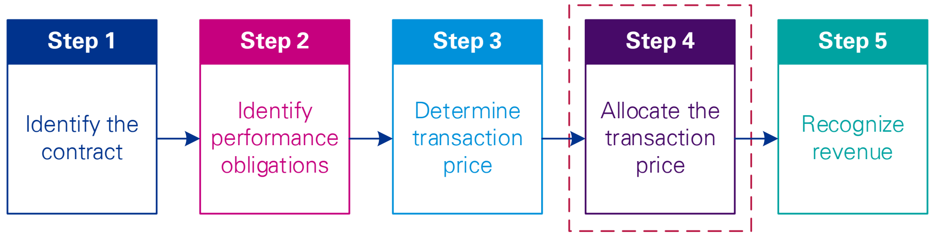
Determine stand-alone selling prices

Allocate the transaction price

Allocating a discount

Changes in the transaction price

Material rights



This chapter is organized into distinct sections as follows:

- Overview
- Determine stand-alone selling prices
- Allocate the transaction price
- Allocating a discount
- Allocating variable consideration
- Changes in the transaction price
- Material rights

Overview

Excerpt from ASC 606-10

> Allocating the Transaction Price to Performance Obligations

32-28 The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

32-29 To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the **contract** on a relative **standalone selling price** basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).

32-30 Paragraphs 606-10-32-31 through 32-41 do not apply if a contract has only one performance obligation. However, paragraphs 606-10-32-39 through 32-41 may apply if an entity promises to transfer a series of distinct goods or services identified as a single performance obligation in accordance with paragraph 606-10-25-14(b) and the promised consideration includes variable amounts.

Step 4 of the revenue model requires an entity to allocate the transaction price to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer (the 'allocation objective').

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

This step of the revenue model comprises two sub-steps that an entity performs at contract inception:

Determine stand-alone selling prices → **Allocate the transaction price**

Determine stand-alone selling prices

Excerpt from ASC 606-10

>> Allocation Based on Standalone Selling Prices

32-32 The standalone selling price is the price at which an entity would sell a promised good or service separately to a **customer**. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service.

32-33 If a standalone selling price is not directly observable, an entity shall estimate the standalone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 606-10-32-28. When estimating a standalone selling price, an entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances.

32-34 Suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:

a. Adjusted market assessment approach—An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
b. Expected cost plus a margin approach—An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
c. Residual approach—An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable

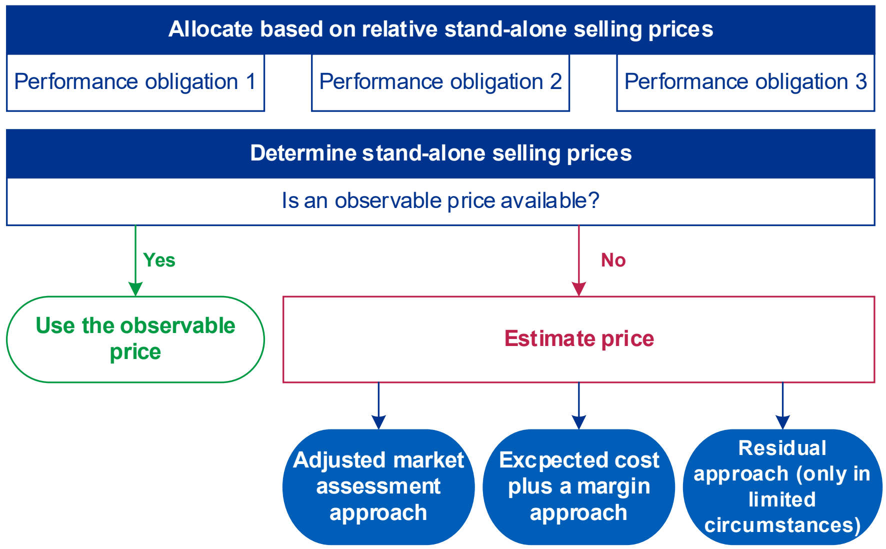
standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:

1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).
2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

32-35 A combination of methods may need to be used to estimate the standalone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain standalone selling prices. For example, an entity may use a residual approach to estimate the aggregate standalone selling price for those promised goods or services with highly variable or uncertain standalone selling prices and then use another method to estimate the standalone selling prices of the individual goods or services relative to that estimated aggregate standalone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the standalone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated standalone selling prices would be consistent with the allocation objective in paragraph 606-10-32-28 and the guidance on estimating standalone selling prices in paragraph 606-10-32-33.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of this is an observable price from stand-alone sales (which includes stand-alone renewals) of the good or service to similarly situated customers. A contractually stated price or list price could be the stand-alone selling price of that good or service, but this is not presumed to be the case and would need to be supported by other evidence.

If the stand-alone selling price is not directly observable, then the entity estimates the amount using a suitable method as illustrated below. In limited circumstances, an entity may estimate the amount using the residual approach.



Estimating stand-alone selling prices

An entity considers all information that is reasonably available when estimating a stand-alone selling price – e.g. market conditions, entity-specific factors and information about the customer or class of customer. It also maximizes the use of observable inputs and applies consistent methods to estimate the stand-alone selling price of other goods or services with similar characteristics.

Topic 606 does not preclude or prescribe any particular method for estimating the stand-alone selling price for a good or service when observable prices are not available but describes the following estimation methods as possible approaches.

Adjusted market assessment approach	Evaluate the market in which goods or services are sold and estimate the price that customers in the market would be willing to pay
Expected cost plus a margin approach	Forecast the expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service
Residual approach (limited circumstances)	Subtract the sum of the observable stand-alone selling prices of other goods or services promised in the contract from the total transaction price

Often, there will not be observable stand-alone selling prices for all of the goods or services in a contract with a customer. As a result, significant judgment will often be involved in estimating a stand-alone selling price of those goods or services. While some entities may already have robust processes in place, others will need to develop new processes with appropriate internal controls for estimating stand-alone selling prices of goods or services that are not typically sold separately.

Reasonably available information that may be considered in developing these processes might include:

— **reasonably available data points:** e.g. costs incurred to provide the good or service such as the cost of providing professional services (e.g. implementation, training or services), profit margins, supporting documentation to establish price lists, third party or industry pricing, and contractually stated prices;

— **market conditions:** e.g. market demand, competition, market constraints, awareness of the product and market trends;

— **entity-specific factors:** e.g. pricing strategies and objectives, market share and pricing practices for bundled arrangements; and

— **information about the customer or class of customer:** e.g. type of customer, geography or distribution channels.

The following framework may be a useful tool for estimating and documenting the stand-alone selling price and for establishing internal controls over the estimation process.

Gather all reasonably available data points

↓

Consider adjustments based on market conditions and entity-specific factors

↓

Consider the need to stratify selling prices into meaningful groups

↓

Weigh available information and make the best estimate

↓

Establish processes for ongoing monitoring and evaluation

Question E10

Must an entity establish a stand-alone selling price for each performance obligation?

Interpretive response: Yes. The stand-alone selling price is determined at contract inception for each performance obligation. Topic 606 does not require that the amount can be 'reliably' estimated, nor does it prescribe another threshold. An entity is required to maximize the use of observable inputs when it estimates the stand-alone selling price, but in all circumstances it will need to arrive at a stand-alone selling price for each performance obligation and allocate the transaction price to each performance obligation in the contract.

There are no circumstances in which revenue recognition is postponed because the determination of a stand-alone selling price is difficult or highly subjective.

Comparison to legacy US GAAP

Under legacy US GAAP software revenue recognition guidance, a delivered item (e.g. a software license delivered upfront) was only accounted for as a separate element of the arrangement if the software entity had VSOE for all of the undelivered elements (e.g. PCS, professional services, hosting services, or any specified update or specified additional software product). If the entity did not have VSOE for all undelivered items, the delivered item (typically a software license) was combined with the undelivered items and the revenue attributable to those items was generally recognized either over the period the services were provided (e.g. in the case of PCS or professional services) or at the point in time the undelivered item was delivered (e.g. when a specified upgrade was delivered).

In contrast, under Topic 606, the presence or absence of VSOE for undelivered items has no effect on whether two promised goods or services in a software licensing arrangement are separate performance obligations. For entities that were not able to establish VSOE for the undelivered items in their software arrangements, the elimination of the VSOE requirement will result in more items in software licensing arrangements being accounted for as separate performance obligations. For these entities, this will generally mean that some of the arrangement consideration will be recognized earlier (i.e. when control of the software license transfers to the customer) than under the legacy guidance.

Question E20

How often does an entity need to establish a stand-alone selling price for a particular performance obligation?

Interpretive response: It depends. As noted in Question E10, an entity is required to estimate the stand-alone selling price at contract inception for each performance obligation in a contract. However, the stand-alone selling prices for previously allocated arrangements are not revised even if the stand-alone selling price changes after contract inception but before satisfying all of the performance obligations in a contract. In the case of a contract modification that is not accounted for as a separate contract, the entity would use stand-alone selling prices at the date of the modification to account for the modified contract (see *Chapter G – Contract modifications*).

The stand-alone selling price should be determined for each performance obligation at contract inception and should reflect currently available information, including shifts in pricing, customer base, product offerings or technology. Practically, the frequency of updating the estimated stand-alone selling prices for the purposes of accounting for new contracts will vary based on the nature of the performance obligations, the markets in which they are being sold and various entity-specific factors. For example, a new product offering, new geographical market, goods or services in a highly competitive market or high rate of technological changes may require more frequent updates to the estimated stand-alone selling price as market awareness and demand change. In contrast, when the products, markets and customer base are more stable, some entities may reasonably conclude that the stand-alone selling price of a performance obligation does not change frequently.

Depending on the particular facts and circumstances some entities may reasonably be able to conclude that stand-alone selling prices established on a monthly, quarterly or annual basis would reflect the stand-alone pricing for that entire time period. Entities will need to establish a monitoring process in order to ensure the stand-alone selling prices used appropriately reflect the current circumstances at the inception of each contract.

Question E30

Could a single good or service have more than one stand-alone selling price?

Interpretive response: Yes. Paragraph 606-10-32-32 states the best evidence of stand-alone selling price is the price when the good or service is sold separately in similar circumstances and to similar customers. As such, the stand-alone selling price of a particular good or service could vary based on the circumstances and type or class of customer.

When determining the stand-alone selling price for a good or service, an entity should consider stratifying stand-alone selling prices into meaningful groups and identifying a different stand-alone selling price for each group. The groups could be based on customer type, volume of sales to customers, geography, distribution channel or other relevant groupings.

Question E40

Is the stand-alone selling price required to be a point estimate or can it be a range of prices?

Interpretive response: A point estimate is required in order to allocate the transaction price to the performance obligations for a given contract. However, it may be acceptable for a point estimate to be drawn from a range of prices when that range is sufficiently narrow. Using a range would be most appropriate when stand-alone selling prices are expected to vary somewhat for similar types of customers. A range should be narrow and based on an analysis that maximizes observable inputs and supports an assertion that any price within that range would be a valid pricing point if the performance obligation were sold on a stand-alone basis.

Topic 606 does not discuss ranges of prices. Accordingly, entities will need to exercise judgment in establishing that its range of prices is sufficiently narrow under the circumstances. One approach that would maximize observable inputs would be a bell-shaped curve approach. Under this approach, an entity would evaluate whether stand-alone prices during recent periods are sufficiently clustered within a narrow range.

When the dispersion in stand-alone prices is so wide that a relevant price is not determinable from the observable transactions, an entity should use another method to estimate the stand-alone selling price. That is, the entity would estimate the stand-alone selling price using the adjusted market assessment, expected costs plus margin, or residual approaches (see Question E80). However, the observable prices would still be used as a data point in the estimate of the stand-alone selling price of the performance obligation.

It would not be appropriate to establish a range of observable transactions and then arbitrarily expand the range by a certain percentage on either side of the observable range to create a reasonable range of estimated stand-alone selling prices. Similarly, it would not be appropriate to derive a point estimate (i.e. a stand-alone selling price that is not based on observable selling prices) and arbitrarily add a range of a certain percentage on either side of the point estimate.

Comparison to legacy US GAAP

The approach and methods available for establishing a range of stand-alone selling prices could require more judgment than the legacy practice of establishing VSOE, for which acceptable practice was more established. However, a range that was sufficient to establish VSOE under legacy US GAAP would likely be sufficiently narrow to establish a range under Topic 606.

Question E50

Can the stated contractual price be the stand-alone selling price?

Interpretive response: It depends. Paragraph 606-10-32-32 states that a contractually stated price may be (but shall not be presumed to be) the stand-alone selling price of that good or service. To that end, contractually stated prices may provide a relevant data point when determining the estimated stand-alone selling price of a good or service in some cases.

If the stated price in the contract is developed using methods and assumptions consistent with an entity's normal pricing processes and practices for stand-alone sales of the good or service, the contract price may be useful in the analysis. This is particularly the case if the stated prices for the good or service are reasonably consistent across similar customers regardless of what other goods or services are bundled in the arrangement or the good or service is sold separately and the cash consideration tied to the delivery of the good or service is consistent with its stated price.

When the stated contract price is at stand-alone selling price or is a price within a sufficiently narrow range of observable stand-alone selling prices, it may be appropriate to use the stated contract price as the estimated stand-alone selling price of a good or service. However, if the stated contract price for any of the performance obligations in the arrangement is not an appropriate estimate of the stand-alone selling price, then it will be necessary for the entity to use other information in developing the stand-alone selling price for that performance obligation.

Example E50.1

Allocating the transaction price based on stated contract prices

Entity N sells one-year of SaaS and upfront implementation services for a total fee of $555,000. Entity N determines that the SaaS and the implementation services are separate performance obligations (see Question C280). There is no variable consideration, or discounts that are required to be allocated entirely to one or more but not all of the performance obligations.

The stated contract prices for the goods and services are as follows.

Performance obligation	Contract price
One year of SaaS	$505,000
Implementation services	50,000
Total	**$555,000**

N has established a sufficiently narrow range of observable stand-alone selling prices for its SaaS and implementation services.

Performance obligation	Range of stand-alone selling prices
One year of SaaS	$500,000 to $525,000
Implementation services	$48,000 to $50,000

Because the stated contract prices for SaaS and implementation services fall within the narrow ranges, the stated contract price may be used, without adjustment, to allocate the transaction price to each performance obligation.

Question E60

When the stand-alone selling price is a range, what point in the range should the entity use as the stand-alone selling price when the stated price in the contract is outside that range?

Interpretive response: An entity should develop policies for estimating stand-alone selling prices that are consistent with the allocation objective and are applied consistently. This may include a consistent policy to determine which price in the range of stand-alone selling prices should be used as the stand-alone selling price for purposes of determining the transaction price allocation. For example, an entity may consider a policy of using either (1) the midpoint of the range or (2) the outer limit of the range nearest to the stated contract price for that performance obligation.

Example E60.1

Contract prices are not at stand-alone selling price

Assume the same facts as Example E50.1 except that the total fee for the arrangement is $540,000, with stated contract prices of $485,000 for the SaaS and $55,000 for the implementation services. N's policy is to use the midpoint of its narrow range of observable stand-alone selling prices when stated contract prices fall outside the established ranges when performing the relative stand-alone selling price allocation.

Because the stated prices for the SaaS and implementation services fall outside their respective estimated selling price ranges, consistent with its policy, N allocates the transaction price using the midpoints of the ranges, as follows.

Performance obligation	Stated price	Stand-alone selling price	Selling price ratio	Price allocation
One year of SaaS (midpoint of range)	$485,000	$512,500[1]	91.3%	$493,020
Implementation services (midpoint of range)	55,000	49,000[2]	8.7%	46,980
Total	**$540,000**	**$561,500**	**100.0%**	**$540,000**

Notes:

1. Mid-point of range $500,000 – $525,000 is used because stated contract price is outside the narrow range.
2. Mid-point of range $48,000 – $50,000 is used because stated contract price is outside the narrow range.

Question E70

Is an entity required to use an observable stand-alone selling price as the stand-alone selling price for a distinct good or service if one exists?

Interpretive response: Yes. If observable stand-alone selling prices can be obtained those prices must be used. While the Boards did not specify a hierarchy of evidence to determine the stand-alone selling price of a good or service, paragraph BC276 states that Topic 606 requires an entity to use observable prices when a good or service is sold separately. However, stand-alone historical sales may not be determinative on their own.

Paragraph 606-10-32-32 states that the best evidence of stand-alone selling price is the observable price when the entity sells that good or service separately (which would include the price of actual renewals for PCS and when-and-if upgrades) in similar circumstances and to similar customers. However, if the entity is selling the good or service in a new market, to a new customer type or under different circumstances (e.g. market factors have affected the pricing for the particular good or service), then other data points may be more relevant. In that situation, the historical sales should be used as an observable input in developing an estimate of the stand-alone selling price for that new circumstance. We would expect an entity to use the most relevant stand-alone sales prices and adjust based on other relevant factors to determine the stand-alone selling price.

When the historical stand-alone sales are not within a sufficiently narrow range, those sales may not provide evidence of an observable stand-alone selling price because the range is so wide that an appropriate pricing point is not observable. In that situation, an entity will need to estimate the stand-alone selling price using another method that maximizes the use of observable inputs (that would include those historical sales as inputs). See Question E40 on determining an observable stand-alone selling price that is a range.

An entity may sell a good or service separately, but only on occasion. In this situation, the entity would evaluate whether the historical sales for that good or service when it is sold separately are indicative of the price that it would charge in a similar situation. For example, if the entity has not sold a software product on a stand-alone basis within a reasonable period of time before the current transaction (e.g. six months to one year), the previous sales price for that product may not be indicative of the stand-alone selling price of the product in the current contract. In that situation, the entity may not have an observable stand-alone selling price and should estimate the stand-alone selling price using another approach. However, the historical sales should be considered in the estimate.

Question E80

Does an entity have a 'free choice' in selecting a method for estimating the stand-alone selling price for a good or service when the entity has determined the good or service does not have an observable stand-alone selling price?

Interpretive response: No. An entity must select the method that maximizes the use of observable inputs. Paragraph 606-10-32-34 discusses suitable methods for estimating stand-alone selling prices but does not specify a hierarchy or preference to those methods – other than that it restricts the circumstances in which an entity may use a residual approach (see Question E90) *and* states that the estimation method used should maximize the use of observable inputs. Topic 606 does not preclude or prescribe any particular method for estimating a stand-alone selling price provided the estimate is a faithful representation of the price at which the entity would sell the distinct good or service as if it were sold separately to the customer. [606-10-32-33, ASU 2014-09.BC268]

Because entities are required to maximize the use of observable inputs, entities would look first at estimation techniques that rely on observable inputs before using techniques more heavily reliant on non-observable inputs. Consider the following situations.

— Assume an entity has observable inputs (stand-alone sales that are not sufficiently clustered around a narrow range or third-party sales of a similar good or service), while its fulfillment costs (see Question E160) information does not provide relevant data. In that case, the entity would use the adjusted market assessment approach (using the observable entity and third-party sales inputs) rather than estimating the stand-alone selling price based on the non-relevant cost data (i.e. using an expected cost plus a margin approach).

— In contrast, assume an entity has observable, reliable historical cost data for similar goods or services but observable third-party pricing for similar goods or services is not consistent. The entity would likely conclude that the expected cost plus a margin approach is more appropriate. However, if the entity has observable market data, such as competitor pricing or stand-alone sales, the entity would still consider those data points when evaluating the appropriateness of the cost plus margin estimate.

— If an entity has either observable market data or observable cost plus margin data and either of those approaches provides a faithful representation of the stand-alone selling price, those approaches would be used before the residual approach because they maximize the use of observable inputs. In contrast, the lack of direct observable market inputs or cost data for a particular good or service may result in a conclusion that the residual approach is the estimation approach that maximizes observable inputs because the residual approach uses the observable inputs from the other goods or services in the contract. Note, however, that the residual approach may only be used in certain circumstances (See Question E90).

Ultimately, when an observable stand-alone selling price is not available, the use of an alternative measure is not a free choice. In all cases, the entity's estimate of the stand-alone selling price should maximize the use of observable inputs.

Comparison to legacy US GAAP

Under legacy US GAAP for non-software arrangements, the arrangement consideration was allocated to all deliverables meeting the separation criteria on the basis of their relative selling price, unless some other specific guidance applied – e.g. software arrangements and separately priced warranty contracts – and subject to contingent consideration restrictions (i.e. the contingent cash cap). Legacy multiple-element arrangement guidance required an entity to determine the selling price for each deliverable using the following hierarchy:

- vendor-specific objective evidence (VSOE) of the selling price, if it existed;
- third-party evidence of the selling price, if VSOE did not exist; or
- the best estimate of the selling price, if neither VSOE nor third-party evidence existed.

Similar to the requirement to use VSOE first, Topic 606 requires an entity to use 'observable prices' (which might be a different threshold than VSOE) when it sells a good or service separately. However, Topic 606 does not prescribe an explicit hierarchy or a particular method for estimating the stand-alone selling price when an observable price is not available. Rather, it requires an entity to maximize the use of observable inputs in estimating the stand-alone selling price of the good or service.

For example, even if an entity can obtain third-party evidence of the selling price, the entity may be able to use an alternative estimation method provided the alternative method equally maximizes the use of observable inputs. Whereas, under legacy US GAAP, an entity would be required to use third-party evidence before establishing its best estimate of the selling price using an alternative approach.

In practice under legacy US GAAP, third-party evidence of selling price of substantially similar goods or services could be difficult to support and entities may have developed best estimates of selling price using other approaches. The adjusted market assessment approach under Topic 606 is similar to, but not the equivalent of third-party evidence of selling price under legacy US GAAP. Under Topic 606, the adjusted market assessment approach is not limited to third-party pricing of a similar good or service. Rather, the third-party sales would be considered observable inputs that the entity could use in making its market assessment estimate. For example, even if a third-party sale did not qualify as third-party evidence under legacy US GAAP, under Topic 606 the entity could consider those sales as observable data points and then make appropriate adjustments to estimate the stand-alone selling price of the good or service.

Question E90
When can a software entity use the residual approach?

Interpretive response: The residual approach is appropriate only if the stand-alone selling price of one or more goods or services is highly variable or uncertain, and observable stand-alone selling prices can be established for the other goods or services promised in the contract.

Selling price is…	…if…
Highly variable	The entity sells the same good or service to different customers at or near the same time for a broad range of prices
Uncertain	The entity has not yet established the price for a good or service and the good or service has not previously been sold on a stand-alone basis

If two or more goods or services in a contract have highly variable or uncertain stand-alone selling prices, then an entity may need to use a combination of methods to estimate the stand-alone selling prices of the performance obligations in the contract. For example, an entity may use:

— the residual approach to estimate the aggregate stand-alone selling prices for all of the promised goods or services with highly variable or uncertain stand-alone selling prices; and then
— another technique to estimate the stand-alone selling prices of the individual goods or services in the bundle that was determined by the residual approach.

The residual approach is appropriate for estimating the stand-alone selling price of a software license when, and only when, the selling price is highly variable or uncertain. Further, there is often little or no incremental cost to the software entity (so a cost plus a margin approach would be inappropriate) and the software product may not have substantially similar market equivalents from which to derive a market assessment. As a consequence, in the case of a software license the residual approach will frequently be the method that maximizes the use of observable inputs.

However, another approach may be more appropriate for other goods or services even if the criteria to use the residual approach are met. Topic 606 requires that the method used to estimate stand-alone selling price should maximize the use of observable inputs (see Question E80) and when there are observable inputs such as third-party pricing or cost and margin data from selling similar goods or services another approach may be more appropriate.

The residual approach should be used only when the criteria are met and the approach results in an estimated selling price at which the entity would sell the promised good or service separately. See also Question E100.

Software licenses are not typically sold separately and may be offered in a wide range of differently priced bundles. Software vendors will need to consider both quantitative and qualitative factors to determine whether the selling price of software or a bundle of goods or services is highly variable or uncertain. See

Question E110 for considerations on whether the selling price of a bundled software license is highly variable. See Question E120 for considerations on whether the selling price of a good or service is uncertain.

Example E90.1

Estimating stand-alone selling price – residual approach

Software Vendor M enters into a contract to provide rights to use Licenses S and T for three years, as well as technical support for both licenses. The contract price is $100,000.

M has identified four performance obligations in the contract: License S; technical support for License S; License T; and technical support for License T. M determines that the licenses and the related technical support are each distinct and, therefore, separate performance obligations (see Questions C120 and C160).

The stand-alone observable price of $12,500 is available for the technical support for each of the licenses, based on renewals that are sold separately at that price. However, the prices at which M has sold licenses similar to Licenses S and T to similar customers in other bundled transactions have been in a broad range – i.e. selling prices of the licenses are highly variable and not directly observable. Also, the level of discounting in the bundled arrangements varies based on negotiations with individual customers.

M determines the stand-alone selling prices of the performance obligations in the contract as follows.

Performance obligation	Stand-alone selling price	Approach
Licenses S and T	$ 75,000	Residual approach ($100,000 – $12,500 – $12,500)
Technical support for License S	12,500	Directly observable price
Technical support for License T	12,500	Directly observable price
Total	**$100,000**	

The residual approach is used to estimate the stand-alone selling price for the bundle of products (Licenses S and T) with highly variable selling prices. Because the licenses will transfer to the customer at different points in time, M then estimates the stand-alone selling price of each license. It does this by allocating the $75,000 to Licenses S and T based on the average residual stand-alone selling price for each license over the past year, as follows.

Product	Average residual selling price	Ratio	Price allocation	Calculation
License S	$ 40,000	40%	$30,000	($75,000 × 40%)
License T	60,000	60%	45,000	($75,000 × 60%)
Total	**$100,000**		**$75,000**	

The approach used by M to estimate the stand-alone selling prices of Licenses S and T is an example of one approach that may be acceptable; however, other approaches may be acceptable (e.g. estimating the stand-alone price based on the entity's internal pricing practices) if they are consistent with the allocation objective and maximize the use of observable inputs.

Comparison to legacy US GAAP

Using the residual approach to estimate stand-alone selling prices under Topic 606 may yield similar results to legacy guidance on multiple-element arrangements in some circumstances.

Although the residual approach is not permitted for estimating the selling price under the legacy US GAAP guidance applicable to transactions that do not include a software license, the amount that would be allocated may be one of several data points identified when developing an estimated selling price for the delivered element. In addition, the use of the residual method of allocation was permitted in legacy US GAAP for:

— software arrangements in which the entire discount was allocated to the delivered item(s) in the contract and for which there was VSOE for all of the remaining undelivered elements in the contract; and
— deliverables bundled together with a separately priced extended warranty or maintenance obligation, in which the stated price was allocated to that obligation and the residual was allocated to the remaining deliverables in the contract.

The residual approach under Topic 606 differs from the residual method permitted under legacy US GAAP software revenue recognition guidance, in that:

— it can be used to develop an estimate of the stand-alone selling price of a good or service, rather than to determine the allocation of consideration to a specific performance obligation – although in many circumstances it will result in the same outcome;

— the amount allocated to the delivered item could be zero under legacy US GAAP; however, that would not be appropriate under Topic 606 (see Question E100);

— its application is not limited to delivered items – i.e. a reverse residual approach is allowed if the requirements for its use are met for an undelivered performance obligation; and

— it requires only observable stand-alone selling prices of other goods or services that are promised in the contract, which may allow greater application of the residual method than the requirement to establish VSOE.

Given that an entity is no longer required to have VSOE for all the undelivered items in a software arrangement, and it is required to estimate the stand-alone selling price for each distinct good or service, Topic 606 may accelerate revenue recognition for many multiple-element software arrangements.

Question E100

Can the residual approach result in zero or very little consideration allocated to a good or service?

Interpretive response: No. If applying the residual approach results in zero or very little consideration being allocated to a good or service, or to a bundle of goods or services, then this outcome may not be reasonable. (Note that this is different to allocating consideration between items that are and are not in the scope of Topic 606, which may result in little or no consideration being allocated to the aggregate of the items that are in the scope of Topic 606 – see *Chapter A – Scope*).

If an entity has determined that a good or service is distinct, then by definition it has value to the customer on a stand-alone basis. In this case, an entity considers all reasonably available data and whether the stand-alone selling price of that good or service should be estimated using another method.

Question E110

How should an entity evaluate whether the selling price of a software license that is always bundled with PCS is highly variable?

Interpretive response: In order to apply the residual method, the selling price of the good or service must be highly variable or uncertain. Paragraph 606-10-32-34(c)(1) states that the selling price of a good or service is highly variable if "the entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative stand-alone selling price is not discernible from past transactions or other observable evidence)."

Software entities commonly sell software licenses bundled with other goods and services such as PCS. Often the software license is never sold on a stand-alone basis and is always bundled with such services. As a result, the stand-alone selling price of the license is not directly observable, and an entity will need to estimate the stand-alone selling price of the license.

When the entity has not sold a license on a stand-alone basis it may not be clear whether the selling price is highly variable. That is because without stand-alone sales the entity may not easily be able to establish that the license was sold for a broad range of amounts.

An entity may be able to evaluate whether the selling price of a license that is always sold with PCS is highly variable by evaluating the pricing of the bundle. This is because the nature of the combined items, lack of observable data points and significance of the license to the overall arrangement could indicate that the variability was attributable to the license. However, if an entity sold a bundle that includes items other than a license and PCS (e.g. a bundle of professional services and a license), it would need to consider the nature of the bundled items before evaluating the pricing of the bundle. In other cases, the nature of bundled goods or services (e.g. implementation services) may make it less likely that the value of the license is driving the variability in pricing.

In cases where the pricing of a bundled license and PCS is highly variable, it generally would be reasonable to conclude the selling price of the license is highly variable. Consider the following examples:

— **The selling price of the bundle is highly variable, and the entity has observable stand-alone selling price for PCS based on a fixed dollar amount.** For example, if the entity has consistently priced PCS through renewals such that it has established a fixed dollar observable stand-alone selling price (or a narrow range of prices), it would be reasonable to conclude that highly variable pricing of the bundle is related to the license. For example, if the stand-alone selling price of PCS was $100 and the entity sold the license and bundled PCS between $500 and $1,000 that might indicate that the range of the license was between $400 and $900.

— **The selling price of the bundle is highly variable and observable prices of PCS are based on a percentage of the stated license fee.** When PCS is priced as a percentage of a stated license fee that varies from customer to customer, the license fee would be highly variable from a fixed dollar perspective and it would be reasonable to conclude that the selling price of the license is driving the variability in the pricing of the bundle.

When the stand-alone selling price of a license and bundled PCS is highly variable, the contract may also include additional performance obligations with observable stand-alone selling prices. In that case, the residual approach may first be used to allocate consideration between the bundle and the performance obligation(s) with observable selling prices. This might occur, for example, in an arrangement to provide a license, PCS and professional services when the entity has an observable stand-alone selling price for the professional services and highly variable pricing for the license and PCS as a bundle.

Question E120

How should an entity evaluate whether it has established a price when it has not yet sold a good or service separately – i.e. whether the selling price is uncertain?

Interpretive response: In order to apply the residual approach, the selling price of the good or service must be highly variable or uncertain. Paragraph 606-10-32-34(c)(2) states that the selling price of a good or service is uncertain if "the entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain)."

Even when an entity has not sold a good or service on a stand-alone basis, it may still have established a price for the good or service. That is because the entity may have established an internal list price or made an offer to a customer at that price.

It may be difficult to demonstrate that an entity has established a price until a good or service has been sold separately on a regular basis. However, the selling price could still be uncertain if the good or service has been sold separately but those sales are infrequent or not current.

A price could be established price when an entity has set a price for a good or service based on its customary business practices if the entity expects that the good or service will regularly be sold separately at that price. That is because the price may not be substantive without the expectation of entering into separate sales at that price.

When evaluating whether a price has been established before stand-alone sales, an entity will need to apply significant judgment and should consider the following when making its evaluation (not exhaustive).

— Other observable inputs provide evidence that the price has been established. For example, if third-party pricing for similar products is consistent with the price the entity set, that would indicate that the price is not uncertain.

— The length of time between when the price is set and when the entity expects to sell the good or service. The greater the length of time until, or uncertainty about when, the good or service will be sold, the higher the likelihood that the price is uncertain.

— The entity's historical experience of selling previously released goods or services for the price set by management. If the entity has a history of setting a price and that price changes before selling the good or service separately it would indicate that the price is uncertain.

— The frequency of which the entity expects to sell the good or service on a stand-alone basis. If the entity does not expect to sell the good or service separately on a regular basis, it would indicate the price is uncertain because an expectation of regular stand-alone sales might change how an entity sets the price for the good or service.

— The entity has offered customers a contractually stated renewal price and has a history of customers exercising the option at that stated price for similar goods and services. If a customer has not yet exercised an option to renew, the price may still be uncertain if the entity has a history of customers renegotiating the contract to purchase a renewal at a different price.

— The nature of the good or service and the entity's experience with similar products. If the goods or services are based on a new technology or service offering and the entity lacks historical experience to demonstrate that a price established will be used in stand-alone sales, the selling price may be uncertain. In contrast, if the new good or service is similar to existing goods or services provided by the entity or goods or services sold by competitors, there might be more certainty in the selling price.

Even if the selling price is considered uncertain, an entity is required to maximize the use of observable inputs in estimating the stand-alone selling price of a good or service. The presence of contractually stated prices for renewal options, stand-alone sales of similar products, or third-party sales of similar goods or services would likely be considered observable data points that an entity would need to consider in its estimation process and therefore it might conclude that a method other than the residual approach should be used in estimating the stand-alone selling price even if the entity has concluded that the price is uncertain.

Question E130

Can the stand-alone selling price of PCS be expressed as a percentage of the license fee?

Interpretive response: It depends. The stand-alone selling price of PCS can be expressed as a percentage of a stated license fee or a fixed dollar amount. A history of stand-alone sales at a consistent percentage of the stated license fee to which the PCS relates establishes a value relationship between the PCS and license that can be indicative of the stand-alone selling price of each. However, all facts and circumstances should be considered, and a renewal rate expressed as a percentage of the stated license fee is not automatically considered to be the stand-alone selling price for PCS.

Having a stated PCS renewal rate that is 'substantive' is not enough to use that renewal rate as the stand-alone selling price of the PCS. However, an entity can establish an observable stand-alone selling price for the PCS expressed as a percentage of the stated license fee if that pricing is consistent with the entity's normal pricing practices and it has a sufficient history of customers renewing at a substantially similar percentage.

Similar to establishing a stand-alone selling price at a fixed dollar amount, the entity could stratify its population of PCS sales into meaningful groups when determining the consistency of pricing. Further, the entity could establish a range of percentages as the observable input to determining the stand-alone selling price if the range is sufficiently narrow. However, if the actual renewal percentages are highly variable, further analysis and refinement will be required to meet the allocation objective for the performance obligations in bundled arrangements.

Estimating the stand-alone selling price

If observable stand-alone sales (i.e. renewals) are not consistent enough to establish an observable percentage (or narrow range of percentages) as the stand-alone selling price for the PCS, an entity would need to estimate the stand-alone selling price of the PCS. An estimated, rather than observable, stand-alone selling price can still be expressed as a percentage of a stated license fee, and as with other stand-alone selling price estimates, the entity's estimation approach must maximize the use of observable inputs. Because renewals at stated percentages are an observable input, they would be a valid data point in the estimate (i.e. even if not tightly banded enough to produce an observable stand-alone selling price). In addition, an entity might consider industry benchmarks, competitor pricing at similar renewal percentages, the entity's pricing practices and other relevant, observable data points in developing an estimated stand-alone selling price for PCS expressed as a percentage.

Comparison to legacy US GAAP

Under legacy US GAAP guidance, a PCS renewal rate expressed as a percentage of the stated license fee constitutes vendor-specific objective evidence of fair value (VSOE) for PCS if the renewal percentage was substantive. This could be the case even if the PCS was renewed for differing amounts (i.e. because the stated license fee differed from contract-to-contract). Because Topic 606 refers to observable pricing as the amount that the good or service is sold on a stand-alone basis, if the renewal percentage is not priced consistently from customer to customer, the stated percentage may not be representative of the stand-alone selling price even if it were determined to be substantive under legacy US GAAP.

Even if a renewal rate of the stated license fee is not considered an observable stand-alone selling price, under Topic 606, an entity would still be required to separate PCS from a license if both are distinct (as would typically be the case – see Questions C160 and C170). While under Subtopic 985-605 if VSOE were not established the PCS and license could not be separated.

If the PCS renewal rate was substantive under legacy GAAP but is not a representative stand-alone selling price (which may still be a percentage of the license fee) under Topic 606, the amounts allocated to PCS and the license could be different.

Example E130.1

Contractually stated renewal rates of PCS expressed as a percentage of a license fee

KF Corp enters into a contract with Customer X to provide a perpetual software license to Product A and technical support and unspecified updates, upgrades, and enhancements (collectively, PCS) for a period of one year commencing with the transfer of the license. After conclusion of the initial PCS period, PCS may be renewed annually for an amount equal to 20% of the stated license fee of $1,000,000. The stated price of PCS in the initial contract was $200,000.

KF concludes that the software license and PCS are two performance obligations (see Questions C150 – C170).

KF consistently prices PCS renewals at 20% of the stated license fee for Product A and has an established history of customers renewing at that percentage. However, the price of the license is uncertain because the entity has never sold a license to Product A separately and has not established a price for it.

KF concludes that it has observable inputs to establish the stand-alone selling price for Product A PCS as 20% of the stated license fee because it has a history of observable renewals priced at 20% of the stated license fee. This establishes an observable value relationship between the license and the PCS. As a result, it concludes that the stand-alone selling prices of the PCS and the license are $200,000 ($1 million × 20%) and $1 million, respectively. As a result, KF allocates $200,000 to the PCS and $1 million to the license.

KF concludes that this allocation of the transaction price is consistent with the allocation objective and depicts what it would expect to receive for those goods or services because the relative allocation is consistent with its normal pricing practices and KF's other customers would have a similar percentage allocation. KF also notes that using the observable relationship of the selling price between PCS and the license fee is the approach to determining the stand-alone selling prices of each that maximizes the use of observable inputs. This is because the expected cost plus a margin approach would not be relevant and there are no observable inputs directly related to the license on which to base an adjusted market assessment approach.

Example E130.2

Contractually stated renewal rates of PCS expressed as a percentage of a license fee bundled with professional services

Assume the same facts as Example E130.1 except that KF enters into a contract with Customer Y that also includes professional services priced at $300,000. Therefore, the total contract fee is $1,500,000. The stated contract price for professional services is commensurate with the observable stand-alone selling price for those services.

KF has observable stand-alone selling prices for the professional services and PCS (see Example E130.1) but the stand-alone selling price of the license is uncertain. As a result, KF applies a residual approach to estimate the stand-alone selling price of the license. KF allocates $300,000 to the professional services and $200,000 to PCS. KF then estimates the stand-alone selling price of the license to be $1,000,000 ($1,500,000 – $300,000 – $200,000).

Example E130.3

Contractually stated renewal rates of PCS expressed as a percentage of a license fee – renewal rates do not represent stand-alone selling price

Assume the same facts as Example E130.1 except that KF enters into a contract with Customer Y with a stated contract license fee of $1,000,000 and a stated renewal rate of 15%. However, KF consistently prices renewals of PCS at 20% of the stated license fee, which is determined to be an observable input to establishing the stand-alone selling price of the PCS.

In this situation, KF would not use the stated renewal percentage as the stand-alone selling price of the PCS because it is not reflective of what KF would expect to be entitled to in a contract with a similar customer – i.e. the rate in this contract is effectively at a discount from KF's normal pricing practices.

Similar to Example E130.1, KF concludes that the stand-alone selling price of PCS is $200,000 (20% normal renewal price × $1,000,000). KF also evaluates the renewal option for the presence of a material right to obtain discounted PCS (see *Chapter C – Step 2: Identify the performance obligations in the contract* for a discussion of material rights).

Question E135**

Can the stand-alone selling prices of a software license and PCS both be expressed as percentages of the transaction price?

Interpretive response: Yes. Question E130 is not intended to suggest that only the stand-alone selling price of PCS can be expressed in the form of a percentage. The ultimate objective of determining stand-alone selling prices for the software license and the PCS is to permit an appropriate allocation of the transaction price to those items on a relative basis. Therefore, it may often be reasonable and simpler to look to the value relationship between the two items to allocate the transaction price, instead of determining a fixed dollar estimated stand-alone selling price for each.

Value relationship in this context simply refers to the ratio of the transaction price to be allocated to the license and the PCS (e.g. 80/20, 40/60). Therefore, the transaction price allocation to the license and the PCS that results from an appropriately determined value relationship should not differ from that which would result from using appropriately determined fixed dollar stand-alone selling prices. As such, there is no reason to ascribe preferability to one approach (value relationship or fixed dollar stand-alone selling prices) or the other.

Question E140#

How can an entity estimate the stand-alone selling prices of software term licenses and PCS sold together as a bundle?

Interpretive response: Entities often sell software term licenses and PCS *only* as a co-terminus bundle. If the license and the PCS are separate performance obligations (see Questions C160 and C170), and assuming the PCS is a single performance obligation (see Question C150), an entity will need to determine the stand-alone selling prices of both the license and the PCS. However, if a co-terminus license and PCS are always bundled together, both when the license is initially granted and upon renewal, the entity will not have observable stand-alone sales for either. As a result, the entity will need to estimate the stand-alone selling price of each (or establish the 'value relationship' between the two (see Question E135).

To estimate the stand-alone selling prices or the value relationship in these situations, entities must apply an approach that maximizes the use of observable inputs. Potential observable inputs include (not exhaustive):

— **Stand-alone PCS renewals:** An entity may sell PCS renewals on a stand-alone basis in relation to perpetual or long-term licenses of the software product. A perpetual (or long-term) license and a term (or shorter term) license for the same software product are generally similar and the nature of the related PCS would typically be substantially the same (i.e. both typically consist of the same technical support and updates and enhancements). A stand-alone renewal (expressed as a percentage of the license fee or fixed dollar amount) of PCS over the same software product would be an observable input that could be a *starting point* for the estimates with appropriate adjustments for the differences in rights between the perpetual (or longer term) licenses and term (or shorter term) licenses. For example, given the time restrictions on a term versus a perpetual license (including the time the customer will benefit from PCS-provided updates), the price at which an entity might sell the term license and PCS on a stand-alone basis may be different from the prices for a perpetual license and PCS.

  While not *as* closely related, stand-alone renewals of PCS for a *similar* software product may also constitute a reasonable starting point for the estimates, provided that the technical support and updates, upgrades and enhancements are reasonably comparable to those expected to be provided for the software product in question. Additional adjustments – i.e. in addition to those for time restrictions (perpetual versus term) – may be necessary for differences between the software products and the nature of the PCS provided for each product.

— **Industry benchmarks or other external data:** Industry benchmarks, competitor pricing for PCS renewals or publicly disclosed information of similar companies may be other observable inputs that can serve as starting points (from which to make appropriate adjustments) for estimating stand-alone selling prices of or the value relationship between a co-terminus license and PCS.

Relevant stand-alone PCS pricing data exists

When the entity or industry consistently prices renewals of PCS on a perpetual (or long-term) license to the same or substantially similar software product as a percentage or fixed dollar amount, it may establish an observable value relationship between the perpetual (or long-term) license and PCS; this established relationship may be helpful in estimating the stand-alone selling prices for the PCS and the term license. However, adjustments to the observed value relationship or fixed dollar stand-alone selling price of the PCS may be appropriate. For example, an entity might consider the following (not exhaustive).

— **Economic life of the software.** If the term of the license is equivalent to the economic life of the software, using the pricing for PCS related to a perpetual license may be appropriate. In contrast, if the term is shorter than the economic life of the software, adjustments from the perpetual pricing of the PCS may be necessary to reflect a different value relationship (e.g. because the customer will have rights to use the updates received only for the term of the time-based license, rather than perpetually).

— **Length of the license term.** The longer the term of the license, the generally greater value the customer obtains from PCS because the customer will have the right to use any updates, upgrades or enhancements for a longer period of time and there is a higher likelihood that they are necessary to keep the software current.

- **Length of the PCS term.** If committed PCS in a multi-year term license arrangement is for more than one year (including up to the full length of the license), that will generally result in a greater allocation of the total transaction price to the PCS than in a scenario where the committed PCS is only for a one-year period. As such, it would not be appropriate to apply a renewal percentage derived from the pricing of one-year PCS to estimate the gross amount to be allocated to multiple years of PCS.
- **Significance of PCS elements.** The entity may have a history of providing frequent updates and enhancements such that the primary value driver of PCS is in those updates and enhancements. By contrast, more of the value of the PCS may be associated with technical support (e.g. if that technical support is more proactive or 'high touch'). Depending thereon, an entity might make different adjustments to reflect the different value proposition associated with the term and perpetual license. For example, if more of the value from the PCS comes from technical support, the value relationship between the license and the PCS may be less affected by the term nature of the license than if most of the value of the PCS comes from the right to receive updates, upgrades or enhancements, which the customer will have rights to for only a limited time in a term license.
- **Internal pricing strategies.** An entity's pricing practices between bundled sales of perpetual (or longer term) licenses and term licenses may be relevant, including the reasons for the different pricing practices.

Relevant stand-alone PCS pricing data *does not* exist

Some entities do not sell PCS on a stand-alone basis at all; for example, they may not sell perpetual or long-term licenses. They *only* sell co-terminus software licenses and PCS for all their software products. And many proprietary software products do not have relevant peer products (or relevant peer products for which observable pricing information exists).

In these circumstances, entities must still maximize the use of observable inputs when estimating stand-alone selling prices of their software licenses and PCS; however, identifying observable inputs may be more challenging than when stand-alone PCS pricing data exists. We have observed that entities in these circumstances often look to industry and peer data. For example, an entity may look to the value relationship between a competitor's software licenses and PCS, implied by the competitor's publicly available financial statement disclosures, as a data point from which to *start* its own value relationship assessment.

If an entity uses observable market information, it must be careful not to place inappropriate reliance on that information. Inappropriate reliance may occur if the entity uses relevant peers' value relationships or pricing data in its own estimates without adjusting for differences between its own software products, licenses and PCS and those of the peer companies. The following differences may exist that, if not adjusted for, could lead to inappropriate allocations of transaction price (not exhaustive).

— **Differences in license terms**. In general, all other things being equal, one would expect the value relationship to skew more heavily toward the PCS than the term license the longer the co-terminus license and PCS term is. Therefore, an entity should adjust from peers' value relationship data if the entity's license terms are shorter or longer than those of its peers.

— **Importance of software updates, upgrades or enhancements**. The peer companies' software may be affected differently by obsolescence or maintenance issues than the entity's software. If the entity is reasonably expected to make more frequent and/or substantive software releases than its peers to address these issues, one would usually expect the value relationship between its licenses and PCS to be more heavily weighted toward the PCS than that of its peers. We would expect the converse to also be true.

— **Level of technical support**. A peer company's technical support may differ from the entity's. For example, the peer company's technical support may only be available during business hours, while the entity's is available 24 × 7 × 365; or the entity may promise a faster issue response time. Another difference may be in the level of customer interaction; some technical support is solely response oriented (i.e. respond when called), while other technical support is more proactive or 'high touch' (e.g. proactively offering guidance, reviews and/or diagnostics to the customer). All else being equal, one would usually expect the value of PCS with proactive, higher coverage or faster response technical support to be greater in relation to the bundled software license than PCS with reactive, lesser coverage or slower response technical support.

Example E140.1

Estimating stand-alone selling price in a term license with PCS

Assume the same facts as Example E130.1 except that KF also sells Product A on one-year, three-year, and five-year term licenses with co-terminus PCS. The license and PCS are separate performance obligations in the term license arrangements (see Questions C160 and C170).

KF prices a one-year term license bundled with one year of PCS at $400,000, a three-year license bundled with three years of PCS at $1,200,000 and a five-year license bundled with five years of PCS at $2,000,000. KF does not sell term licenses or PCS related to a term license separately and therefore must estimate the stand-alone selling price of each in its customer contracts. KF also notes that the PCS is substantially the same service as in a perpetual license with the only difference being the term and the software product to which the customer obtains a right of use is the same product. The economic life of Product A is estimated to be five years.

To estimate the stand-alone selling prices for the licenses and PCS, KF starts with the observable input available, which is the stand-alone selling price for PCS related to a perpetual license that equates to 20% of the stated license fee. KF also observes there is very little incremental cost of producing the software license and providing the when-and-if-available updates, and the cost of technical support is fixed so that the cost of providing the service to a single customer does not provide a relevant data point. Further, KF's competitors do not sell PCS related to term licenses separately (and their software products are different) so there are no relevant observable third-party data points available on which to base its estimate.

As a result, KF starts with the observable input of annual PCS renewals sold on the perpetual license at 20% of the stated license fee and makes adjustments based on relevant differences between the term and perpetual licenses and related PCS. The following is an example of one approach that may be acceptable.

Scenario 1: One-year term license

KF concludes that the value relationship established between one year of PCS and the stated license fee in a perpetual license would require an adjustment because the one-year term is significantly less than the economic life of the software and the customer would lose any updates after a year. As a result, the same value relationship for a single year would not exist for PCS in a term license compared to one year of PCS in a perpetual license.

KF estimates the appropriate adjustment based on its customary pricing practices and reduces the value relationship of PCS to the term license to 15%. KF's history of updates and enhancements is that they typically are released semi-annually and do not significantly alter the functionality of the software. As a result, no additional adjustments are needed to take into account differences in the term and perpetual license scenarios.

To extrapolate the amount allocated to the license and PCS based on the adjusted perpetual license pricing, KF uses the ratio of the 15% of the net license fee to estimate the allocation on a total contract basis. For example, in Example E130.1 the total contract value was $1,200,000 and PCS based on 20% of the net license fee was $200,000. As such, PCS was approximately 17% ($200,000 ÷ $1,200,000) of the total contract value. The ratio used for the term license would then be stated as [(15% × number of years) ÷ (1 + (15% × number of years))].

Using the same methodology, KF estimates the ratio to be 13% [15% ÷ (1 + 15%)] attributable to PCS and 87% to the license. KF allocates $52,000 ($400,000 × 13%) to the PCS and $348,000 ($400,000 × 87%) to the license.

Scenario 2: Three-year term license

KF concludes that the value relationship established between one year of PCS and the stated perpetual license fee would require an adjustment for the three-year term license for similar reasons to the one-year term license. While the license is for a longer period of time, KF concludes that the PCS would still have less value than PCS associated with a perpetual license scenario; principally because the customer will, again, only have rights to any updates received for the term of the license (rather than perpetually). However, the value relationship would be greater than in a one-year license scenario.

KF estimates the appropriate adjustment based on its internal pricing strategy, which is to reduce the value relationship to 18% (i.e. from 20%) for a three-year term license. KF estimates that 35% [(18% × 3) ÷ (1 + (18% × 3))] of the transaction price should be allocated to PCS and 65% to the license. Therefore, KF allocates $420,000 ($1,200,000 × 35%) to PCS and $780,000 ($1,200,000 × 65%) to the license.

Scenario 3: Five-year term license

KF concludes that it should use the annual stand-alone selling price percentage of PCS in a perpetual license to estimate the allocation based on the following.

— The term covers a substantial portion of the economic life of the software, and KF expects the value of a five-year license and a perpetual license to be similar.

— The nature of the PCS is therefore substantially the same.

— KF's internal pricing strategy prices a five-year term license consistent with a perpetual license with bundled PCS and annual renewals.

KF estimates that 50% of the transaction price [(20% × 5) ÷ (1 + (20% × 5))] should be allocated to PCS and 50% should be allocated to the license. As a result, KF estimates the stand-alone selling price of the PCS to be $1 million (50% × $2 million total fee) and stand-alone selling price of the license is the residual amount of $1 million. KF notes that the amount allocated to the license and PCS is consistent with the perpetual license scenario in Example E130.1 for the reasons outlined in the preceding paragraph.

Conclusion

The example scenarios above illustrate one way an entity may approach making the estimate of stand-alone selling price for a term license and term license PCS, and other approaches may be acceptable provided the entity maximizes the use of observable inputs when developing the estimate. For example, an entity might conclude that the stand-alone selling price of PCS in a term license should be closer to the stand-alone selling price of PCS in a perpetual license if the updates were more frequent and important or if more of the value proposition of the PCS was in the technical support. In addition, the adjustments from the perpetual PCS pricing (e.g. 20% to 18% in Scenario 2) are based on the specific facts and circumstances and should not be assumed to be the appropriate adjustment in all one, three or five-year term license scenarios.

Question E145**

What effect does software being 'open-source' have on allocating transaction price between a software license and co-terminus PCS?

Background: An entity may offer a substantially comparable software product to one it licenses on an open-source basis. Open-source means entities and individuals can access the software for free.

Entities that follow this model often offer a superior (e.g. 'enterprise') version of the open-source software – e.g. a version with some additional features and functionality – for commercial license, usually bundled with co-terminus PCS.

In these scenarios, the question arises as to how the open-source software's free accessibility affects the value relationship between the entity's enterprise version software licenses and related PCS.

Interpretive response: In general, the approach to allocating the transaction price between an enterprise software license and co-terminus PCS does not differ from that outlined in Question E140.

However, *in addition* to the considerations outlined in that question, we believe an entity would typically consider the availability of a significant portion of the enterprise software's features and functionality for free (i.e. through the open-source software) when estimating the stand-alone selling price of the enterprise license or determining the value relationship that exists between the license and the PCS. In general, we believe this would usually result in:

- a lower stand-alone selling price of the enterprise software license (as compared to a license for similar software without an open-source version); and
- a value relationship between the license and the PCS more weighted toward the PCS.

And the greater the overlap in features and functionality between the open-source and enterprise software versions, the (1) lower the stand-alone selling price of the enterprise software license and (2) greater the allocation of transaction price to the PCS versus the enterprise license. For example, all else being equal, we would generally expect more of the transaction price to be allocated to the PCS if the open-source version of the software has 90% of the features and functionality of the enterprise version instead of only 50%.

The effect of the features and functionality overlap on the enterprise license stand-alone selling price and/or the value relationship between the license and the PCS may not directly correlate to the extent of that overlap. For example, the difference in transaction price allocation between the 90% and 50% scenarios in the preceding paragraph may not correlate exactly with the quantitative difference in the overlap. This is because other factors may also affect the stand-alone selling price of the license or the PCS, or the value relationship that exists between the two. These factors include the following (not exhaustive).

- **Nature and timing of updates, upgrades or enhancements provided to open-source and enterprise users**. Enterprise PCS customers may receive more meaningful and/or more timely updates than open-source software users. For example, the entity may:
  - focus more of its R&D efforts on improving or enhancing its enterprise-only features or on fixing bugs related to enterprise features; or
  - provide updates that apply to both the enterprise and open-source software versions to enterprise customers sooner than it makes those same updates freely available to open-source users.

  We would typically expect these (or similar enterprise benefits) to increase the stand-alone selling price of, and skew the value relationship more toward, the PCS. By contrast, if enterprise PCS customers do not receive benefits of this nature (or similar), that may indicate that the stand-alone selling prices of the enterprise license and the PCS are *both* affected by the entity's open-source model. In that case, the entity's transaction price allocation between the enterprise software license and PCS may be less differentiated by this factor from that of a similar software vendor without an open-source version of its software.

— **Enhanced technical support.** We have observed that the enterprise PCS offered by many entities in the scope of this question often includes proactive or 'high touch' technical support (see Question E140). As stated in Question E140, all else being equal, one would usually expect the stand-alone selling price of PCS with proactive, higher coverage or faster response technical support to be higher in relation to the software license than PCS with reactive, lesser coverage or slower response technical support.

  In the context of this question, this means that higher-level technical support (versus lower-level support) could, for example, *add* to the value relationship effect of the features and functionality overlap (i.e. further skew the value relationship toward the PCS) or at least partially offset effects of the nature described in the preceding bullet of PCS that does *not* prioritize updates to enterprise PCS customers.

— **Importance of enterprise-only software features.** It is likely relevant to consider the importance customers attach to the enterprise-only software features. It may be clear from usage statistics or other evidence that, despite enterprise-only software features comprising only a small percentage of the total features and functionality available in the enterprise software, those features are disproportionately used or employed by enterprise customers. In that case, any adjustment to the enterprise license stand-alone selling price or to the proportionate value of the license in the license/PCS value relationship stemming from the features and functionality overlap likely should be smaller than it would be if the enterprise-only features are used in a similar fashion and with a similar frequency to open-source features.

  For example, if there is a 90% overlap between the enterprise and open-source software features, an entity would generally expect the value relationship to skew more toward the PCS if customers are using all features of the software relatively equally than if customers are using the enterprise-only software features more extensively than those features also present in the open-source software.

Question E150

Would it be acceptable to use an entity-published price list as evidence to estimate a stand-alone selling price?

Interpretive response: It depends. Similar to contractually stated prices for goods or services in a contract containing multiple performance obligations, published price listing cannot be presumed to represent an appropriate estimate of stand-alone selling price. However, a published list price may be a relevant data point that should be considered in determining the stand-alone selling price of a good or service.

In many cases, a published price list serves as a starting point for price negotiations for a good or service. An entity may sell certain goods or services included on the price list on a stand-alone basis. Analyzing the discounting practices for similar goods or services sold on a stand-alone basis can provide observable data points that are relevant and useful in corroborating the estimated selling price for the goods or services that are not sold on a stand-alone basis.

Question E160

What costs should an entity consider when estimating a stand-alone selling price using the expected cost plus a margin approach?

Interpretive response: Paragraph 606-10-32-34 states that under the expected cost plus a margin approach the entity could forecast its expected costs of satisfying a performance obligation. Subtopic 340-40 provides guidance on the accounting for costs to fulfill a contract and the costs eligible for capitalization are costs that are directly related to the contract. As such, it would be consistent with the requirements in paragraphs 340-40-25-7 through 25-8 to consider the types of costs that relate directly to a contract, when estimating costs to fulfil (i.e. satisfy) a performance obligation. Those costs are summarized in the following table.

Direct costs to be included in the estimate ✓	Costs that should be excluded from the estimate ✗
Direct labor – e.g. employee wages	**General and administrative costs** – unless explicitly chargeable under the contract
Direct materials – e.g. supplies	**Costs that relate to satisfied performance obligations**
Allocation of costs that relate directly to the contract – e.g. depreciation and amortization	**Costs of wasted materials, labor or other contract costs**
Costs that are explicitly chargeable to the customer under the contract	**Costs that do not clearly relate to unsatisfied performance obligations**

Direct costs to be included in the estimate	Costs that should be excluded from the estimate
Other costs that were incurred only because the entity entered into the contract – e.g. subcontractor costs	

When fulfillment costs are directly in the scope of other guidance (for example, Topic 330 on inventory), entities' determination of cost should be consistent with the requirements for those goods or services. For example, if an entity manufactures a server but does not sell the server on a stand-alone basis, we would expect entities to consider only inventoriable costs when developing its measure of costs plus margin to estimate stand-alone selling price. However, research and development costs in the scope of other guidance would typically be excluded from the estimate of costs to fulfill a performance obligation as they are not related to fulfillment of a contract.

See Question E170 for further details on the margin used in the expected cost plus a margin approach.

Question E170

How does an entity determine what margin to use when developing a cost plus margin data point to estimate a stand-alone selling price?

Interpretive response: Determining the margin to use when developing an expected cost plus margin estimate requires the exercise of significant judgment, particularly when historical profit data has not been tracked on a disaggregated product by product grouping basis. It may be necessary for an entity to gather reasonably available margin data points and make adjustments for market conditions and entity-specific factors to arrive at the best estimate of a reasonable profit margin. It may also be necessary to establish separate margins for different classes of sales transactions based on different geographical markets, customer classes or other meaningful groups. The profit margins used should be consistent with the costs used in the estimate (see Question E160) to reflect the expected margin on those particular costs. Consideration of the following factors may be appropriate when estimating a reasonable margin to be reflected in a cost plus margin data point:

— Average profit margins within an entity's product or service lines can provide evidence of the margin it can expect to attain if the product or service were sold separately. Adapting this margin to a specific good or service within the group could be necessary, particularly if there are specific items in the good or service family with characteristics expected to have different margins.

  - The nature of the good or service should be considered to determine whether it warrants a premium or a discount from the average profit margin. For example, some items might be sold in high volumes or might not have significant value-added attributes, even though the entity considers them to be in the same product group.

- A competitor's profit margins realized for similar goods or services may provide relevant data points.
  - It may be necessary to consider the competitive position of an entity's goods or services relative to competitors' goods or services to determine a profit margin that the market would be willing to pay. For example, best-in-class goods or services or those with enhanced functionality or sold by an entity with a dominant market share likely will have higher profit margins than a competitor's margins. Similarly, if a competitor has goods or services with enhanced functionality, or benefits from being best in class, an entity may not expect to be able to attain a similar margin in the same market.
  - It may be necessary to consider a competitor's cost structure to determine whether its profit margins require adjustment relative to the entity's expected margin.
  - It may be necessary to consider how long the competitor has sold the product compared to the entity's product. If the entity is developing a new product that will compete with a long-standing product offering of a competitor, the entity may expect to have lower profit margins as it obtains market share.
- Third parties and industry trade groups may publish average profit margin data for goods and services in a particular industry. This external pricing data may provide a relevant data point when determining a reasonable margin for certain goods and services. An entity should consider the effect of market conditions and entity-specific factors on an entity's estimated margin when using such external data.
- An entity may have established processes, for example through a pricing committee or otherwise, for establishing reasonable margins for certain goods and services sold on a stand-alone basis. How margins are determined for goods and services similar to those not sold on a stand-alone basis may provide a relevant and useful data point for determining a reasonable margin.

No one individual data point is likely to be determinative of a margin that should be used in a cost plus margin assessment, and the weight given to each data point in determining an entity's best estimate will vary depending on facts and circumstances. However, any estimate will need to maximize the use of observable inputs.

Question E180

How should an entity determine the stand-alone selling price for implied updates, upgrades and enhancements during an installation period?

Interpretive response: In some arrangements, the customer installs a software package (this may be done by a third party, the customer or the software entity) for an undefined period of time and the contractual PCS term commences when installation is complete. The software entity may not provide technical support services to the customer before when installation is completed (which is typically when a contractual PCS term will commence), but it may have a history of providing updates, upgrades, and enhancements that are released during the installation period (implied updates upgrades and enhancements).

The implied updates, upgrades and enhancements would be a promised service in the contract (see Question C190) and, consistent with Question C170, would typically be distinct from the software license. The implied updates, upgrades, and enhancements may have a different measure of progress (e.g. the entity might use a measure based on percent complete of the installation) from the updates, upgrades and enhancements during the contractual PCS term (which would be a measure of progress that does not correspond to progress toward implementation), in which case the implied updates, upgrades, and enhancements and contractual period updates, upgrades and enhancements would not be a single performance obligation that is comprised of a series of distinct services. As such, the entity would need to allocate the transaction price to three performance obligations: (1) the software license, (2) implied updates, upgrades and enhancements and (3) contractual PCS (assume the entity accounts for the component services of PCS as a single performance obligation consistent with Question C150).

An entity would determine the stand-alone selling price for implied updates, upgrades and enhancements in a manner similar to other goods or services. The entity would first consider whether it has observable stand-alone selling prices for updates, upgrades and enhancements sold separately for an undefined period of time. Oftentimes an entity may have observable stand-alone selling prices for a typical PCS arrangement (i.e. technical support and updates, upgrades and enhancements) but does not sell when-and-if-available updates, upgrades and enhancements separately and, even when it does, those sales would typically be for a defined period of time (e.g. one year). As a result, the entity would need to estimate the stand-alone selling price of the implied updates, upgrades and enhancements.

When developing the estimate for implied updates, upgrades and enhancements, the entity would need to consider the pricing for typical PCS because it is an observable data point. For example, one approach would be to start with observable prices for the typical PCS and make adjustments for differences in fulfillment costs or other market factors, as well as the fact that no technical support is being provided during this period. It also would need to consider the uncertainty as to the time period in its estimate of the pricing for the implied updates, upgrades and enhancements. However, other approaches may be acceptable if they maximize the use of observable inputs.

Comparison to legacy US GAAP

Under legacy US GAAP, the entity would typically use the VSOE of fair value for a typical PCS arrangement (which includes both technical support services and rights to unspecified updates, upgrades and enhancements) to allocate the arrangement consideration to implied updates, upgrades and enhancements and license. If the entity does not sell upgrades and enhancements only as a separate service, it would not be appropriate for an entity to allocate an amount less than the full VSOE of fair value of a typical PCS arrangement to the implied PCS.

Under Topic 606, the entity will be able to estimate the stand-alone selling price of only updates, upgrades and enhancements rather than using stand-alone selling price for a typical PCS arrangement. As such, the amount allocated to the implied updates, upgrades and enhancements under Topic 606 may be less than what would have been allocated under legacy US GAAP.

Question E190

How should a software entity determine the stand-alone selling price for PCS when software is deployed over time and the contract contains a stated renewal rate for post-deployment period PCS?

Interpretive response: A software entity may enter into arrangements in which the software product will be deployed in stages and the entity will provide PCS over the deployment period. During the deployment period software copies are installed and the number in use increases over the deployment period until the software is fully deployed. The initial contract will often include a stated renewal rate to purchase PCS once the software is fully deployed. Oftentimes, the entity only has observable stand-alone selling prices for fully deployed PCS because it does not sell deployment period PCS on a stand-alone basis. These arrangements generally will have two performance obligations consisting of (1) the software license and (2) deployment period PCS (assume the entity accounts for the component services of PCS as a single performance obligation consistent with Question C150).

Because the entity typically does not sell deployment period PCS separately, it will need to determine whether stand-alone sales of post-deployment period PCS would be representative of the stand-alone selling price for deployment period PCS. The stated renewal rate in the contract for post-deployment period PCS, even if an observable stand-alone selling price, should not be *presumed* to be the stand-alone selling price for deployment period PCS.

To determine whether post-deployment period PCS would provide representative stand-alone selling price for deployment period PCS, a software entity should first consider if the services provided are substantially the same. For example, the entity would consider whether the customer will receive the same level of technical support (e.g. only from 9 a.m. to 5 p.m. or 24 hours a day, 7 days a week) and the same updates, upgrades, and enhancements in the deployment period and post-deployment period.

If the PCS provided during the deployment period is substantially the same as post-deployment PCS, then the entity should evaluate the renewals of fully deployed PCS when the user base is commensurate with the expected user base during the deployment period. For example, a narrow range of PCS renewals on a fully deployed user base that is similar in size to the average user base expected during the deployment period may be representative of stand-alone selling price during the deployment period.

When observable stand-alone selling prices are not available (e.g. the fully deployed PCS is not substantially the same as the deployment period PCS or the user base is not commensurate), the entity would estimate the stand-alone selling price by other means. That estimate could start with the stand-alone selling price of fully deployed PCS, and then adjust for differences in deployment period efforts as compared to fully deployed PCS efforts. Alternatively, the entity could make adjustments to deployment period pricing based on an estimated pro rata difference between a fully deployed user base and expected deployment period user base. No matter the method used, the entity should maximize the use of observable inputs, including the pricing of fully deployed PCS in its estimate.

Comparison to legacy US GAAP

Legacy US GAAP software revenue recognition guidance (paragraphs 985-605-55-53 through 55-55) addressed whether a predetermined renewal rate after the software is fully deployed should be considered VSOE of fair value for PCS during the deployment period.

That guidance stated that a renewal rate after the software was fully deployed should be used to establish VSOE of fair value for PCS because that is the only arrangement under which the PCS is sold separately.

The ability under Topic 606 to estimate a stand-alone selling price for deployment period PCS where observable selling prices do not exist constitutes a significant change from legacy US GAAP. Where the absence of VSOE under legacy US GAAP prevented the software entity from separating the software license from the PCS, the absence of observable selling prices under Topic 606 will not affect the assessment of whether the software license and the deployment period PCS are separate performance obligations, which they typically will be (see Questions C160 and C170).

In addition, if the stand-alone selling price of fully deployed PCS does not represent the stand-alone selling price of deployment period PCS, the entity could use an amount different from (and likely smaller than) the price of fully deployed PCS. This could result in an amount allocated to deployment period PCS under Topic 606 that is less than VSOE of fully deployed PCS. As such, the amount of consideration allocated to deployment period PCS may be less under Topic 606.

Example E190.1
Deployment period PCS

Description of the Arrangement

ABC Corp. enters into an arrangement with Customer to transfer a perpetual license to Product A and to provide technical support and unspecified updates, upgrades and enhancements (collectively, PCS). The Customer will deploy Product A in stages over three years (i.e. ABC will ramp up to its 10,000 permitted seats over the first three years of the license period), with initial deployment of some seats commencing upon transfer of the license (i.e. the deployment period begins when the initial license is transferred). The pace of deployment is in the sole control of Customer, and control of the license transfers upon delivery of the Product A software as Customer has the ability to use and benefit from the software at that point.

The contractual term of PCS commences six months after initial license transfer (i.e. contractual PCS is for a term of 2.5 years). After three years, PCS may be renewed annually for an amount equal to 20% of the $1,000,000 stated contract price for the Product A license. Even though the contractual PCS does not commence for six months, ABC has a customary business practice of providing PCS during the first six months of the deployment period. The total contract price is $1,300,000.

ABC concludes that the contract has two performance obligations: (1) the software license and (2) three years of deployment period PCS. ABC considered whether the six months of implied deployment period PCS and 2.5 years of contractual deployment period PCS were separate performance obligations. ABC concluded that the implied deployment period PCS and contractual deployment period PCS would be a series of distinct services that form a part of a single performance obligation in accordance with paragraph 606-10-25-14(b) because the nature of the promise is the same throughout the three-year period (all deployment period PCS) and both services would have the same pattern of transfer.

ABC only sells PCS separately through renewals on a fully deployed basis. The Product A license is never sold without bundled PCS and the selling price of the license is uncertain.

ABC consistently sells post-deployment renewal PCS at 20% of the stated license fee for a similar class of customers and, consistent with Question E130 and Example E130.1, concludes that the stand-alone selling price for post-deployment PCS to be $200,000 per year.

ABC does not sell deployment period PCS separately; however, ABC evaluates whether the stand-alone selling price of deployment period PCS would be commensurate with the stand-alone selling price of post-deployment PCS. At contract inception, ABC expects the average deployment period user base (based on the estimated timing of the customer reaching full deployment) to be approximately one-half of the fully deployed user base.

While the services are substantially the same (e.g. both provide 9 to 5 technical support and the same when-and-if-available upgrades) for deployment period and post-deployment period PCS, ABC observes that it would not normally sell

PCS to a customer with a similar deployment level for $200,000. Therefore, ABC does not use the same stand-alone selling price for the deployment period because it would not depict what the entity would expect for providing services to similarly sized customers.

ABC has other Product A customers currently in PCS renewal terms with a fully deployed user base that is commensurate with the average deployment period user base that ABC expects for Customer. In those contracts, the renewal rate was 25% of the stated license fee; however, as the user base was smaller, the stated fee was typically lower than the contract price with Customer. ABC observed the 25% was applied consistently and established an observable stand-alone selling price for that class of customer based on a percentage of the license fee. ABC also observed that the fixed dollar prices ranged from $65,000 to $190,000.

ABC estimates the stand-alone selling price for deployment period PCS using the adjusted market assessment approach based on the observable inputs that are the stand-alone sales of fully deployed PCS to customers with a fully deployed user base. ABC concludes that it would sell annual deployment period PCS to Customer for $125,000. This estimate is based on the renewal rate of 25% (i.e. consistent with the rate for a similar user base) and an estimate of an average user base that is 50% smaller during the deployment period ($1,000,000 × 25% × 50%). ABC also notes this price is in the range of observable PCS renewals for a fully deployed user base commensurate with Customer's deployment levels. As such, the stand-alone selling price for the three-year deployment PCS is $375,000 ($125,000 × 3).

ABC next estimates the stand-alone selling price for the license and notes that a residual approach cannot be strictly used because ABC does not have an observable stand-alone selling price for PCS. However, in order to maximize the use of observable inputs, ABC uses observable prices of PCS as there are no observable data points on which to base the estimate of the license. That is, inputs based on cost are not relevant and there is no observable market data for separate sales of the license.

ABC concludes that the stand-alone selling price of the license is the difference between the stand-alone price of PCS and the stated contract amount because the stand-alone selling price of PCS is derived from observable stand-alone sales of fully deployed PCS.

ABC allocates $375,000 to the deployment period PCS and $925,000 ($1,300,000 – $375,000) to the license.

Question E200

How should a software entity determine the stand-alone selling price of PCS provided during a period of unlimited deployment when the contract includes stated renewals of PCS during the deployment period and different prices in the post-deployment period?

Interpretive response: A software entity may enter into arrangements for the sale of perpetual licenses with unlimited deployment (a.k.a. 'all you can eat arrangements') for a stated period of time (e.g. three years) bundled with an initial PCS period that is shorter than the deployment period. The arrangements typically consist of an initial fee with stated amounts representing the perpetual license together with one year of PCS. During the deployment period, the arrangements frequently will contain an option to renew PCS annually for an amount stated in the arrangement. At the end of the deployment period (the three-year period), the PCS renewal fee is determined based on the ultimate number of copies deployed by the end user. That is, there is different pricing for PCS renewals during and after the three-year deployment period.

In the situations described in the previous paragraph, a software entity should determine the stand-alone selling price for the deployment period PCS similar to other PCS arrangements. The stated renewal rate during the deployment period or in the post-deployment period should not be presumed to be the stand-alone selling price. However, if the entity has a history of deployment period PCS being renewed by other customers at similar prices for similar levels of deployment, those renewals may provide evidence of the stand-alone selling price for deployment period PCS.

If observable prices of deployment period PCS are not available, consistent with Question E190, the entity would evaluate whether stand-alone sales of fully deployed PCS provide relevant observable sales prices as well as all other relevant data when estimating the stand-alone selling price for the deployment period PCS. See Question E190 for further discussion.

Comparison to legacy US GAAP

Under legacy software revenue recognition (paragraphs 985-605-55-70 through 55-73) if entities concluded that they could not establish VSOE for the unlimited deployment period PCS due to different pricing methodologies during the deployment period and post-deployment period, the entity would recognize the entire arrangement fee ratably over the applicable deployment period.

Where the absence of VSOE under legacy US GAAP prevented the software entity from separating the software license from the PCS, under Topic 606 this will not affect the assessment of whether the software license and the unlimited deployment period PCS are separate performance obligations. This requirement constitutes a significant change from legacy US GAAP.

Allocate the transaction price

Excerpt from ASC 606-10

>> Allocation Based on Standalone Selling Prices

32-31 To allocate the **transaction price** to each **performance obligation** on a relative **standalone selling price** basis, an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the **contract** and allocate the transaction price in proportion to those standalone selling prices.

At contract inception, the transaction price is generally allocated to each performance obligation on the basis of relative stand-alone selling prices. In most cases, an allocation based on stand-alone selling prices faithfully depicts the amount of consideration to which an entity is entitled for satisfying a performance obligation and the relative stand-alone selling price allocation should be the general method for allocating the transaction price. However, there are situations when a relative allocation may not faithfully depict the amount of consideration to which the entity is entitled.

Topic 606 includes exceptions to the relative stand-alone selling price approach for the following scenarios:

— Observable evidence that a discount relates entirely to one or more, but not all, performance obligations.
— Variable consideration is attributable to one or more, but not all, distinct goods or services.

Comparison to legacy US GAAP

Under legacy US GAAP, the allocation of arrangement consideration to delivered items was limited to amounts of revenue that are not contingent on an entity's future performance. Topic 606 does not have such a limitation, therefore the full estimated transaction price – which includes all amounts, including contingent amounts, to which the entity expects to be entitled – is estimated and allocated on a relative stand-alone selling price basis to each performance obligation without limitation.

However, the estimate of variable consideration may be constrained (see *Chapter D – Step 3: Determine the transaction price*). Nevertheless, Topic 606's removal of the contingent cap may accelerate the recognition of contingent or variable consideration in comparison to legacy US GAAP.

Question E210

Can the sum of the stand-alone selling prices in a contract be less than the total transaction price?

Interpretive response: Generally, no. We generally expect that the sum of the stand-alone selling prices of the individual goods and/or services will be equal to or greater than the bundled contract fee. Customers typically are not willing to pay a premium for a bundle of goods or services when they could purchase the goods or services for less on a stand-alone basis.

In situations when the sum of the stand-alone selling prices is less than the total transaction price, entities should reconsider whether they have identified all of the items that Topic 606 requires to be identified in the contract (e.g. promised goods and services, significant financing components) and whether the stand-alone prices have been properly determined. In particular, entities should evaluate whether the premium is in substance a nonrefundable upfront fee that provides the customer with a material right to purchase additional goods or services or renew the existing contract.

If a premium remains after reconsideration of the points above, the premium generally should be allocated on a relative stand-alone selling price basis with the rest of the transaction price unless there is observable evidence that the premium relates to one or more, but not all, performance obligations. For example, an entity might also consider the guidance on allocating a discount to one or more performance obligations to determine whether there is observable evidence that a premium entirely relates to a bundle of distinct goods or services but not all of the performance obligations in the contract.

Question E220

How are nonrefundable upfront fees treated when allocating the contract's estimated transaction price to the separate performance obligations?

Interpretive response: Nonrefundable upfront fees are considered part of the transaction price. The total transaction price, including any nonrefundable upfront fees, is allocated to the performance obligations in the contract using the relative stand-alone selling price method.

Allocating a discount

Excerpt from ASC 606-10

>> Allocation of a Discount

32-36 A **customer** receives a discount for purchasing a bundle of goods or services if the sum of the **standalone selling prices** of those promised goods or services in the **contract** exceeds the promised consideration in a contract.

Except when an entity has observable evidence in accordance with paragraph 606-10-32-37 that the entire discount relates to only one or more, but not all, **performance obligations** in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract. The proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the **transaction price** to each performance obligation on the basis of the relative standalone selling prices of the underlying distinct goods or services.

32-37 An entity shall 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.
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.

32-38 If a discount is allocated entirely to one or more performance obligations in the contract in accordance with paragraph 606-10-32-37, an entity shall allocate the discount before using the residual approach to estimate the standalone selling price of a good or service in accordance with paragraph 606-10-32-34(c).

The first exception to relative stand-alone selling price allocation relates to discounts attributable entirely to one or more, but not all, performance obligations. In some cases, a proportional allocation of a discount may not depict the amount of consideration to which an entity is entitled for satisfying a particular performance obligation. For example, in a bundled arrangement consisting of high margin and low margin products, a relative allocation of a discount could result in a loss on one part of a contract although the contract as a whole is profitable. [ASU 2014-09.BC277]

In order to apply the exception, an entity needs to have observable evidence that the discount relates to only one or more, but not all, performance obligations in a contract. A discount is only allocated entirely to one or more, but not all, of the performance obligations, if the following criteria are met:

— the entity regularly sells each distinct good or service, or each bundle of distinct goods or services, in the contract on a stand-alone basis;

— the entity also regularly sells, on a stand-alone basis, a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle; and

— the discount attributable to each bundle of goods or services 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(s) to which the entire discount in the contract belongs.

The guidance on allocating a discount will typically apply to contracts with at least three performance obligations. That is because the discount for the good or service (or bundle of goods or services) has to be substantially the same as the discount in the contract. As a result, an entity may be able to demonstrate that the discount relates to two or more performance obligations, but it will be difficult to have sufficient evidence to allocate the discount entirely to a single performance obligation.

Comparison to legacy US GAAP

Generally, under legacy US GAAP, an entity cannot attribute a discount in a contract to one or more separate deliverables, other than when the residual method is used in software arrangements and the entire discount is attributed to the delivered items.

However, the allocation of a discount under Topic 606 is not restricted to particular industries or circumstances – so if the criteria are met, a discount is allocated entirely to one or more performance obligations in a contract, regardless of whether they are delivered or undelivered items.

Question E230

Is an entity required to evaluate whether a discount should be entirely allocated to one or more, but not all, performance obligations in all contracts?

Interpretive response: Yes. The guidance on allocating a discount is not optional. However, practically, this analysis is required only if the entity regularly sells each distinct good or service – or distinct bundle of goods or services – on a stand-alone basis. Therefore, if the entity regularly sells only some of the distinct goods or services in the contract on a stand-alone basis, then the criteria for allocating the discount entirely to one or more, but not all, of the performance obligations are not met and further analysis is generally not required (see Question E240).

Some arrangements involve several different goods or services that may be sold in various bundles. In this case, an entity may need to consider numerous possible combinations of products to determine whether the entire discount in the contract can be allocated to a particular bundle.

Topic 606 does not provide specific guidance on how to evaluate whether a good or service or bundle of goods or services is regularly sold on a stand-alone basis. Entities will need to establish a policy to define 'regularly sells' for different bundles of goods or services.

Example E230.1
Allocating a discount

Company B enters into a contract to license Software Products X, Y and Z for a total amount of $100. Company B regularly sells the licenses individually for the following prices.

Product	Price
X	$ 40
Y	55
Z	45
Total	**$140**

Company B also regularly licenses Software Products Y and Z together for $60.

The contract includes a discount of $40 on the overall transaction ($140 – $100), which would be allocated proportionately to all three products in the contract when applying the relative stand-alone selling price method. However, because Company B regularly sells Products Y and Z as a bundle for $60 and Product X for $40, it has evidence that the entire discount should be allocated to the licenses to Products Y and Z.

The licenses to Products Y and Z are transferred at different points in time, and therefore, the allocated amount of $60 is individually allocated to the Product Y and Z licenses by reference to their relative stand-alone selling prices as follows.

Product	Stand-alone selling price	Selling price ratio	Allocation	Calculation
Y	$ 55	55%	$33	($60 × 55%)
Z	45	45%	27	($60 × 45%)
Total	**$100**	**100%**	**$60**	

Question E240
Can an entity allocate a discount entirely to one or more performance obligations when the stand-alone selling price of one or more of the performance obligations is highly variable or uncertain?

Interpretive response: It depends. When an entity uses the residual approach to estimate the stand-alone selling price of a good or service, an entity first evaluates whether it should allocate an observable discount (i.e. a discount on a bundle of goods or services) to one or more goods or services in the contract. In making this evaluation, the entity would need to consider whether the resulting allocation is consistent with the overall allocation objective in paragraph 606-10-32-28.

A literal reading of the guidance in paragraph 606-10-32-37 may suggest that an entity would rarely, if ever, allocate a discount to one or more, but not all, performance obligations in the contract when there is a performance obligation in the contract that has a highly variable or uncertain stand-alone selling price. This is because the guidance requires that the entity regularly sell each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis and that the entity can quantify the total discount in the contract. Performance obligations with a highly variable or uncertain stand-alone selling price often are not sold on a stand-alone basis, and because the stand-alone selling price is highly variable or uncertain, it may not be possible to quantify the total discount in the contract.

However, paragraph 606-10-32-38 states that if a discount is allocated entirely to one or more performance obligations in the contract, an entity should allocate the discount before using the residual approach to estimate the stand-alone selling price of a performance obligation. This raises a potential conflict in the guidance because it appears that an entity would not be able to apply the allocation guidance in paragraph 606-10-32-37 when the stand-alone selling price of one or more of the performance obligations in the contract is highly variable or uncertain. As such, it is unclear when paragraph 606-10-32-38 would apply.

Example 34 (reproduced below) illustrates scenarios where the residual approach can or cannot be applied to a performance obligation in the contract when there is a directly observable discount on a bundle of goods in a contract. In Case B (paragraphs 606-10-55-265 through 55-268), before using the residual approach, the entity allocated a discount directly to a bundle of goods or services even though the discount in the entire contract was not objectively determinable due to the highly variable or uncertain nature of one of the performance obligations.

We believe, based on discussions at public Board meetings and from informal discussions with the FASB staff, the Examples indicate that before using a residual approach, an entity should evaluate whether it is appropriate to allocate a discount based on observable evidence. In Case B, the entity had evidence that allocating the discount entirely to a bundle was appropriate because the amount allocated to the performance obligation estimated under the residual approach was in the range of the stand-alone selling prices using the residual approach in other contracts. In contrast, Case C illustrated that the discount in the contract should be allocated under the general allocation guidance if allocating a discount entirely to other performance obligations results in an allocation that is inconsistent with the allocation objective.

The approach described above ensures that the discount in the contract is not allocated entirely to that residual good or service. Even if it appears that all of the requirements in paragraph 606-10-32-37 are not met, observable prices of a bundle of goods or services in a contract provide better evidence on which to allocate a discount than the residual approach does. In other words, an estimated stand-alone selling price for the good or service determined by the residual approach may more appropriately depict the price the entity would expect to be entitled to for transferring that good or service *after* taking into account observable prices for the other performance obligations in the contract.

In any case, the entity will need to have observable evidence that supports the allocation of the discount to one or more, but not all, performance obligations that often may be difficult for entities to establish.

Excerpt from ASC 606-10

>> Allocating the Transaction Price to Performance Obligations

>>> Example 34 Allocating a Discount

>>>> Case B—Residual Approach Is Appropriate

55-265 The entity enters into a contract with a customer to sell Products A, B, and C as described in Case A. The contract also includes a promise to transfer Product D. Total consideration in the contract is $130. The standalone selling price for Product D is highly variable (see paragraph 606-10-32-34(c)(1)) because the entity sells Product D to different customers for a broad range of amounts ($15 – $45). Consequently, the entity decides to estimate the standalone selling price of Product D using the residual approach.

55-266 Before estimating the standalone selling price of Product D using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract in accordance with paragraphs 606-10-32-37 through 32-38.

55-267 As in Case A, because the entity regularly sells Products B and C together for $60 and Product A for $40, it has observable evidence that $100 should be allocated to those 3 products and a $40 discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 606-10-32-37. Using the residual approach, the entity estimates the standalone selling price of Product D to be $30 as follows:

Product	Standalone Selling Price	Method
Product A	$ 40	Directly observable (see paragraph 606-10-32-32)
Products B and C	$ 60	Directly observable with discount (see paragraph 606-10-32-37)
Product D	$ 30	Residual approach (see paragraph 606-10-32-34(c))
Total	**$130**	

55-268 The entity observes that the resulting $30 allocated to Product D is within the range of its observable selling prices ($15 – $45). Therefore, the resulting allocation (see above table) is consistent with the allocation objective in paragraph 606-10-32-28 and the guidance in paragraph 606-10-32-33.

>>>> Case C—Residual Approach Is Inappropriate

55-269 The same facts as in Case B apply to Case C except the transaction price is $105 instead of $130. Consequently, the application of the residual approach would result in a standalone selling price of $5 for Product D ($105 transaction price less $100 allocated to Products A, B, and C). The entity concludes that $5 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product D because $5 does not approximate the standalone selling price of Product D, which ranges from $15 – $45. Consequently, the entity reviews its observable data, including sales and margin reports, to estimate the standalone selling price of Product D using another suitable method. The entity allocates the transaction price of $105 to Products A, B, C, and D using the relative standalone selling prices of those products in accordance with paragraphs 606-10-32-28 through 32-35.

Allocating variable consideration

Excerpt from ASC 606-10

>> Allocation of Variable Consideration

32-39 Variable consideration that is promised in a **contract** may be attributable to the entire contract or to a specific part of the contract, such as either of the following:

a. One or more, but not all, **performance obligations** in the contract (for example, a bonus may be contingent on an entity transferring a promised good or service within a specified period of time)
b. One or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) (for example, the consideration promised for the second year of a two-year cleaning service contract will increase on the basis of movements in a specified inflation index).

32-40 An entity shall 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 in accordance with paragraph 606-10-25-14(b) 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).
b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

32-41 The allocation requirements in paragraphs 606-10-32-28 through 32-38 shall be applied to allocate the remaining amount of the transaction price that does not meet the criteria in paragraph 606-10-32-40.

The second exception to the relative stand-alone selling price allocation relates to variable consideration. In some instances, variable consideration does not relate to all of the performance obligations (or distinct goods or services) in a contract. For example, a contract with multiple performance obligations may include a bonus that relates specifically to satisfying one or more, but not all, of the performance obligations. In those situations, it might not be appropriate to allocate variable consideration to all of the performance obligations because it would not depict the amount of the consideration to which the entity was entitled for a particular performance obligation. [ASU 2014-09.BC278]

Variable consideration may be attributable to:

- all of the performance obligations in a contract;
- one or more, but not all, of the performance obligations in a contract – e.g. a bonus that is contingent on transferring a promised good or service within a specified time period; or
- one or more, but not all, of the distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation.

Paragraph BC285 in ASU No. 2014-09 describes the Boards' rationale for allocating variable consideration to portions of a single performance obligation (i.e. distinct goods or services that comprise a single performance obligation).

Excerpt from ASU 2014-09

BC285. The Boards clarified in paragraph 606-10-32-39(b) that variable consideration can be allocated to distinct goods or services even if those goods or services form a single performance obligation. The Boards made this clarification to ensure that an entity can in some cases attribute the assessment of variable consideration to only the satisfied portion of a performance obligation when that performance obligation meets the criterion in paragraph 606-10-25-14(b). Consider the example of a contract to provide hotel management services for one year (that is, a single performance obligation in accordance with paragraph 606-10-25-14(b)) in which the consideration is variable and determined based on two percent of occupancy rates. The entity provides a daily service of management that is distinct, and the uncertainty related to the consideration also is resolved on a daily basis when the occupancy occurs. In those circumstances, the Boards did not intend for an entity to allocate the variable consideration determined on a daily basis to the entire performance obligation (that is, the promise to provide management services over a one-year period). Instead, the variable consideration should be allocated to the distinct service to which the variable consideration relates, which is the daily management service.

When an entity meets the criteria in paragraph 606-10-32-40, the variable amount (and subsequent changes to that amount) is allocated entirely to a performance obligation, or to a distinct good or service that forms part of a single performance obligation. The guidance in paragraph 606-10-32-40 provides two criteria that must be met to allocate variable amounts to one or more, but not all, distinct goods or services.

Variable payment relates specifically to the entity's efforts to satisfy the performance obligation

Assessing this criterion may often be relatively straightforward because the contract terms specifically identify how the variable amounts are resolved and the transfer of goods or services required to earn that amount. When evaluating whether a variable amount relates specifically to a distinct service period, entities should evaluate (a) whether the entity's efforts or customer usage occurs within that time period and (b) whether the variability is resolved in that period. When variable consideration is contingent upon satisfying multiple distinct goods or services (including multiple distinct service periods) or the terms of the payment are dependent on the prior or future periods, the variable amounts typically relate to all of the distinct goods or services required to earn that consideration.

Allocation is consistent with the allocation objective

The allocation objective in paragraph 606-10-32-28 is to "allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer". In order to meet the allocation objective, the entity must consider all of the performance obligations and payment terms in the contract and not just the distinct goods or services to which the variable consideration relates. In other words, the entity considers whether the allocation objective is met for the entire contract.

See Questions E270 through E330 for further information on meeting the criteria to allocate variable consideration to one or more, but not all, distinct goods or services.

Question E250

Is the guidance on allocating variable consideration optional?

Interpretive response: No. Entities must evaluate whether variable consideration in its contracts meets the requirements to allocate the amounts entirely to one or more, but not all, distinct goods or services in the contract.

As a result, whether SaaS or other professional services are a series of distinct services will be an important evaluation when the contract includes variable consideration because an entity might be required to allocate variable consideration entirely to one or more distinct goods or services (or distinct service periods) within the performance obligation. See *Chapter C – Step 2: Identify the performance obligations in the contract*, which discusses identifying when SaaS is considered a performance obligation consisting of a series of distinct goods or services.

Question E260

Which is applied first – the variable consideration allocation guidance or the guidance on allocating discounts?

Interpretive response: The variable consideration allocation guidance is applied before the guidance on allocating discounts in paragraphs 606-10-32-36 through 32-38 or the general allocation guidance in paragraphs 606-10-32-28 through 32-35. In some cases, a contract may contain both variable consideration and a discount. For example, an entity may sell products in a bundle at a discount to the aggregate stand-alone selling prices of the products in the bundle. In addition, the transaction price may include a variable element.

In these cases, an entity applies the guidance on allocating variable consideration before it applies the guidance on allocating discounts. That is, Topic 606 includes an allocation hierarchy. When a contract contains both variable consideration and a discount, applying the respective allocation guidance in the reverse order may result in an incorrect allocation of the transaction price. [606-10-32-41; TRG Agenda Paper No. 31]

Some contracts contain features that may be variable consideration and/or a discount – e.g. a refund resulting from a service level guarantee. In these cases, an entity evaluates the nature of the feature. If the service level guarantee causes the transaction price to be variable – e.g. exceeding a guaranteed percentage of down-time during a period results in a refund (see Question D170 for details on SLAs) – then the entity follows the hierarchy and applies the guidance on allocating variable consideration first. Conversely, if a rebate is fixed and not contingent – e.g. the refund is simply a fixed discount against the aggregate stand-alone selling prices of the items in a bundle – then an entity applies the guidance on allocating discounts or the general allocation guidance and does not consider the guidance on allocating variable consideration.

Question E265

What factors identify whether a variable payment relates specifically to the entity's efforts to transfer a distinct good or service?

Interpretive response: The first criterion to allocate variable consideration to one or more, but not all, distinct goods or services states, "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)." [606-10-32-40(a)]

This criterion is generally met when the variability is solely attributed to and resolved as a result of the transfer of one or more but not all goods or services. This is the case when the amount paid by the customer is independent of the transfer of past or future goods or services (including efforts in previous periods). In other words, the amount paid is resolved entirely as a result of transferring one or more but not all goods or services.

In contrast, this criterion is not met when:

— the variable amount could change based on the transfer of future goods or services. This would mean the variable amounts are attributable to both the current and future goods or services; and

— the variable amount depends on distinct goods or services previously transferred. This would mean that the variable amounts are attributable to not only the final good or service but all of the goods or services transferred before it.

The following are examples of when this criterion is met.

— **Out-of-pocket reimbursements.** Reimbursements of variable amounts related to distinct implementation or installation services but not the subsequent good or service – e.g. SaaS.

— **Performance bonuses.** A performance bonus associated entirely with successfully completing a specified performance obligation.

— **Market-based pricing.** A contract to transfer a distinct good where the price charged is based on the prevailing market rate at the time.

— **Transaction- or user-based fees.** Transaction- or user-based fees that are resolved and linked entirely to the distinct good transferred or performance within a service period, as long as the price per transaction or user does not change as a result of transferring future goods or services. See Question E280 for further details on the transaction-based pricing related to a series of distinct services.

If this criterion is met, the entity also evaluates whether the other criterion (i.e. meeting the allocation objective) is met to allocate the variable amounts entirely to that distinct good or service.

Question E270

In order to allocate variable consideration entirely to a distinct good or service within a single performance obligation, must the allocation result in the same amount (absolute value) being allocated to each distinct good or service within the series?

Interpretive response: No. At the July 2015 TRG Meeting, the TRG discussed the allocation of variable consideration to a series of distinct services in a long-term service contract. The TRG agreed that the allocation of variable consideration to a distinct service period within a single performance obligation would not need to result in the same amount (absolute value) being allocated to each service period within the performance obligation. For example, an annual contract to perform services may consist of daily distinct service periods and the allocation is not required to result in each day having the same amount of variable consideration allocated to each day.

TRG members agreed that Topic 606 does not require a relative stand-alone selling price allocation of the variable consideration because the guidance on allocating variable consideration is an exception to the general rule. While not required, an entity could use stand-alone selling prices to support the reasonableness of the allocation. [TRG Agenda Paper No. 39]

The TRG agreed that judgment will be required to determine when the criteria in paragraph 606-10-32-40 have been met. In particular, determining when the allocation objective in paragraph 606-10-32-28 has been met could be challenging given that Topic 606 does not prescribe how to make that determination.

At the meeting, the TRG discussed several circumstances where the criteria in paragraph 606-10-32-40 would be met in a long-term service contract with a single performance obligation that is composed of a series of distinct daily services. The fact patterns discussed at TRG meetings represent simplified transaction structures, and entities need to carefully evaluate their own facts and circumstances before concluding that the criteria to allocate variable consideration have been met. In some cases, this would involve a careful evaluation of whether the fees are variable or a result of the customer making optional purchases (see Questions C385 and C400). The rest of this discussion assumes any variability based on quantity relates to variable consideration rather than an optional purchase.

Based on that discussion, the following factors may be helpful in evaluating whether variable amounts can be allocated to a distinct good or service period and in particular whether the allocation objective (criterion 606-10-32-40(b)) has been met (not exhaustive):

— **Consistency in prices per unit.** When the variable pricing is based on a per unit amount or formula and that pricing is consistent throughout the contract, the consistency in pricing may indicate that the variable pricing depicts the amount of consideration the entity would expect to be entitled to for providing services (e.g. SaaS) each distinct service period. See Question E280 for further information on a contract with a consistent price per transaction. This factor is most relevant in evaluating an allocation between distinct services that comprise a single performance obligation because when each distinct service period is substantially the same we would expect the entity to price each period in a similar manner unless the entity can support the reasons for changing prices. However, this factor may not be relevant when evaluating an allocation between two performance obligations.

— **Price per unit is commensurate with the price charged separately.** When the entity (or other entities) charges a commensurate price per transaction, per user or other formula on a stand-alone basis it might indicate that the price charged depicts the amount the entity would expect to receive for transferring a distinct service. For example, when a SaaS entity typically charges a similar price per user per month to a customer class, it might indicate that the pricing for each distinct period is consistent with the allocation objective. This factor would be particularly relevant when evaluating the allocation of variable fees in contracts with multiple performance obligations. For example, in a contract to provide two distinct SaaS applications with transaction-based pricing, the allocation objective would not be met when contractual price charged for one service includes amounts attributable to the other service.

- **Consideration is commensurate with the value or benefit to the customer.** A variable fee that reflects the value or benefit transferred to the customer during a distinct service period may indicate that the allocation objective is met. For example, a fee based on usage that is resolved each day may reflect the value to the customer in that period because the customer used the service more frequently in that period. Similarly, each annual performance bonus in a multi-year contract may reflect the performance of the entity and value delivered to the customer in that annual period. In the case of an annual bonus, the bonus would be allocated entirely to the annual period and recognized over that time period based on the measure of progress for the performance obligation.
- **Consideration is commensurate with the entity's efforts to fulfill the service.** A variable fee that reflects the entity's efforts to fulfill the service may indicate that the allocation objective is met. For example, the TRG discussed a contract for hotel management services and noted that reimbursement of variable fulfillment costs in each distinct period would be consistent with the allocation objective. That is because the entity typically would expect to be entitled to a different amount for each distinct service period based on the costs incurred during that time period.
- **Pricing is consistent with the entity's customary pricing practices.** Similar to how an entity would establish stand-alone selling price for a good or service, an entity should evaluate its customary pricing practices to evaluate whether the variable amount depicts the amount the entity would expect to be entitled to for transferring the goods or services. Entities should evaluate all reasonably available data points, market conditions, entity-specific factors and information about the class of customer.
- **Changing prices.** Additional considerations are required when the variable prices change over the contract period even if those changes are consistent with the entity's customer pricing practices. The price may change based on prior usage such as volume rebates based or simply based on the passage of time. See Question E290 for considerations with tiered price and Question E300 for prices that change over time.

The TRG did not discuss all fact patterns where the variable consideration allocation guidance would be applied. For example, the TRG only discussed performance obligations that were a series of distinct service periods while other performance obligations could be a series of distinct quantities. Similarly, the TRG did not specifically discuss allocating variable consideration between multiple performance obligations. As such, in those scenarios an entity would consider the following.

- When a single performance obligation consists of a series of distinct quantities, the entity would evaluate the criteria in paragraph 606-10-32-40 to determine if it could allocate variable fees to each quantity rather than a time period. For example, in a performance obligation that consists of a promise to process 25 transactions rather than a series of distinct time periods, the entity would evaluate whether it could allocate any variable amounts to each transaction instead of a time period.

— When a contract contains multiple performance obligations, the entity needs to evaluate whether a reasonable amount of consideration is allocated to all of the performance obligations when considering all of the payment terms. As such, in order for variable consideration to meet the allocation objective, the entity must evaluate the effects of the allocation on all of the performance obligations. The resulting allocation should reasonably depict what the entity would expect to be entitled to for transferring the goods or services. See Questions E300 and E310 for additional considerations with multiple performance obligations.

Questions E280 through E330 and related examples provide further discussion of the concepts above.

Question E280

When an entity charges a consistent per transaction or per usage fee in a SaaS contract with a single performance obligation can the variable fees be allocated entirely to the period in which they are earned?

Interpretive response: Generally, yes. As discussed in Question D210, when a SaaS performance obligation is comprised of a series of distinct service periods (e.g. a series of distinct daily, monthly or annual periods of service) – which will generally be the case (see the Overview section of *Chapter C – Step 2: Identify the performance obligations in the contract*) – allocating the transaction-based fees to the distinct service period in which the fee is earned is appropriate when both criteria to allocate variable consideration in paragraph 606-10-32-40 are met.

Criterion in paragraph 606-10-32-40(a)

In general, an entity will conclude that a fee that is (1) linked to the volume of transactions processed by, or usage of, the hosted software by the customer during a distinct service period *and* (2) resolved as to its ultimate amount within a distinct service period (e.g. the fee is not subject to rebate or credit in a subsequent period) specifically relates to that distinct service period (i.e. the criterion in paragraph 606-10-32-40(a) will be met).

For example, if a contract for SaaS sets out a fee per transaction or usage of the hosted application (e.g. $1 per transaction processed) that is not subject to *retroactive* adjustment (e.g. a rebate of a portion of the per transaction fees already paid by the customer if a cumulative transaction volume is passed), the criterion in paragraph 606-10-32-40(a) will be met for each day of service provided because the fees relate specifically to the customer's usage during that distinct service period. In contrast, if the $1 per transaction fee can be *retroactively* adjusted to $0.90 or $0.80 per transaction based on transaction volumes that will occur throughout the year, the criterion in paragraph 606-10-32-40(a) would be met for each distinct year of the SaaS performance obligation, rather than each day. See Question E290 for further discussion on volume discounts and rebates

Criterion in paragraph 606-10-32-40(b)

When per transaction or per usage pricing is consistent throughout the contract term, the criterion in paragraph 606-10-32-40(b) will typically be met. That is because the focus of this criterion is on the per transaction pricing structure throughout the contract rather than the estimated transaction or usage volumes for each distinct service period (e.g. each day, month, quarter or year). That is, during each distinct period, the entity would expect to be entitled to a different amount of consideration based on the customer's varying usage of the services (e.g. 100,000 transactions processed in Month 1; 107,000 processed in Month 2; 98,500 in Month 3; etc.). As a consequence, it will generally be the transaction pricing structure that determines whether the allocation objective in paragraph 606-10-32-28 (and therefore the criterion in paragraph 606-10-32-40(b)) is met.

When the transaction-based pricing structure remains consistent among the distinct service periods that comprise a SaaS performance obligation (e.g. a three-year SaaS arrangement), the varying amounts of consideration to which the entity expects to be entitled each period, which are driven by the transaction volume, generally meet the allocation objective because those changing amounts reflect changes in the value to the customer – i.e. the value to the customer of its access to the SaaS correlates with how much the customer makes use of the SaaS.

In a contract with a single performance obligation, the presence of a fixed fee generally will not affect the analysis of whether the variable amounts can be allocated entirely to a distinct service period within the single performance obligation. That is because fixed fees are required to be allocated to the entire performance obligation and cannot be specifically allocated to a distinct good or service within that performance obligation. As such, this would effectively result in the same amount of fixed fee allocated to each distinct service period and the analysis of the variable fees would be the same with or without the fixed fees.

However, contracts will often be more complex and the analysis can become more challenging in contracts with multiple performance obligations or more complex pricing structures. See Questions E290 through E320.

It is also possible a SaaS provider would be able to recognize revenue for a SaaS arrangement that includes transaction- or usage-based pricing using the 'as-invoiced' practical expedient permitted by paragraph 606-10-55-18. *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation* discusses when the 'as-invoiced' practical expedient can be applied.

Example E280.1

Transaction-based fees allocated to the period they were earned

XYZ Corp. provides a hosted software solution to customers for which customers pay a fixed upfront fee and variable amounts based on the number of transactions processed using XYZ's solution. Customers are not permitted to take possession of XYZ's software; therefore, this is a SaaS arrangement (i.e. there is no software license transferred to the customers).

XYZ enters into a contract with Customer to use XYZ's solution for one year. The arrangement consideration consists of a fixed upfront fee of $1,000 and $5 per transaction processed. The quantity of transactions that will be processed is not known and will be billed on a monthly basis.

XYZ concludes that the contract consists of a single performance obligation satisfied over time (see Question F130) of providing access to the hosted solution to Customer. XYZ also concludes that the performance obligation is a series of distinct days of service and that a time-based measure of progress is appropriate for the performance obligation (see Question F240).

XYZ also concludes that variable amounts per transaction should be allocated to the distinct service period (each day) in which the transaction is processed because:

- The variable amounts relate specifically to the customer's usage of the SaaS that day.
- Allocating the transaction-based fees to each day is consistent with the allocation objective because each day has a similar pricing structure and when considering the fixed fee is allocated to all of the days in the contract the resulting allocation of potential variable amounts and fixed fees depicts what XYZ would expect to receive for each day of service.

The fixed fee is attributable to the entire performance obligation and recognized ratably over the contract period.

Assume that Customer processes transactions during the year as follows.

Quarter	Transactions processed	Transaction-based amount billed
Q1	100	$500
Q2	75	$375
Q3	150	$750
Q4	125	$625

Because the variable amounts are attributed entirely to each day within a given quarter, the following amounts would be recognized each quarter.

Quarter	Fixed fee[1]	Variable fees	Total
Q1	$ 250	$ 500	$ 750
Q2	250	375	625
Q3	250	750	1,000
Q4	250	625	875
Total	**$1,000**	**$2,250**	**$3,250**

Note:

1. The total $1,000 fixed fee is recognized ratably over the year using a time based measure of progress.

As discussed in *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*, entities cannot use multiple measures of progress for a single performance obligation. In the example above, the variable fees are allocated to each quarter and recognized using the same measure of progress as the fixed fee. However, because those fees are only allocated to a quarter rather than to the entire performance obligation they are recognized only over the distinct period to which the fees are allocated. The variable and fixed fees being recognized over a different period is a result of the allocation guidance and not applying multiple measures of progress to a single performance obligation.

Question E290

How do volume-based discounts and rebates affect the allocation of variable consideration in SaaS arrangements?

Interpretive response: Pricing arrangements such as these sometimes apply to an entire contract term or to distinct periods within the contract that has variable consideration. For example, a tiered-pricing or volume rebate/credit structure may apply to each month, quarter or year within a longer-term SaaS arrangement and reset at the beginning of the next distinct period. These are just examples as there are many different transaction- and usage-based pricing structures that exist and they frequently co-exist with varied fixed price components. The following are examples of tiered pricing in arrangements with variable consideration.

— Per transaction pricing that decreases *prospectively* as the customer makes greater use of the provider's platform (e.g. $0.10 per transaction for the first 100 transactions; $0.09 per transaction for the next 100; and $0.075 per transaction for those above 200).

— Per transaction pricing that decreases as the customer makes greater use of the provider's platform on a *retrospective* basis. For example, the customer is required to pay $0.10 per transaction for the first 100 transactions, and if the customer reaches that milestone it will pay $0.09 on all transactions going forward *and* receive a rebate (or credit toward future transaction fees) of $0.01 on the first 100 transactions processed.

When a SaaS contract has these types of pricing structures, an entity generally will not be able to allocate per transaction pricing to a distinct period shorter than the contractual period over which the pricing is resolved or reset because the criterion in paragraph 606-10-32-40(a) would not be met. That is because when the price per transaction is dependent on a previous purchase, the variable amount would relate to multiple periods. However, just because the variable amounts relate to multiple periods does not necessarily mean the fees must be allocated to the entire performance obligation.

For example, assume that a contract has a single performance obligation to provide three years of SaaS, with transaction-based pricing.

— If a discount or rebate is earned over the entire three-year period (e.g. based on three-year cumulative transaction volumes), then the variable consideration would be attributable to the entire performance obligation – i.e. when considering the criterion in paragraph 606-10-32-40(a), the variable consideration (e.g. transaction-based fees) earned on any given day relates to the entire performance obligation because those amounts remain variable for the entire three-year term.

— If the measurement period for a discount or rebate resets during the performance obligation period (e.g. resets each quarter or year of the three-year SaaS term) the variable amounts earned each measurement period relate specifically to that period and would be allocated entirely to that measurement period assuming the other criterion in paragraph 606-10-32-40 is met (see Questions E270 and E280).

Example E290.1
Tiered pricing

XYZ Corp. provides a hosted software solution to customers for which customers pay variable amounts based on the number of transactions processed using XYZ's solution. Customers are not permitted to take possession of XYZ's software.

XYZ enters into a contract with Customer to use XYZ's solution for one year. The arrangement consideration consists of a fixed upfront fee and tiered per transaction pricing that resets on a quarterly basis. The per transaction pricing, which resets each quarter, is as follows.

Quantity processed	Price per transaction
0-1,000	$10
1,001-5,000	$ 8
> 5,000	$ 5

XYZ concludes that the contract consists of a single performance obligation of providing Customer access to the hosted solution. XYZ also concludes that the performance obligation is a series of distinct days of service. Because of the upfront fee and tiered pricing, the entity concludes it does not qualify to apply the practical expedient in paragraph 606-10-55-18 to recognize revenue as it has the right to invoice the customer (see Question F310). XYZ determines that a time-based measure of progress is appropriate for the performance obligation. XYZ evaluates whether it should allocate variable amounts entirely to one or more of the distinct service periods.

XYZ first concludes that it does not meet the criterion in paragraph 606-10-32-40(a) to allocate the amounts earned to each distinct day of service because the variable amounts are specifically related to the cumulative number of transactions processed in a quarter rather than each day. That is because the amount earned on the 5,001st transaction is dependent on the previous purchases during the quarter so the variable consideration relates to the entity's efforts to transfer distinct services for all of the days in the quarter.

However, XYZ concludes that it should allocate the variable amounts entirely to the quarter in which they are earned. That is because the pricing resets each quarter such that the variable amounts earned from each transaction processed relate specifically to XYZ's efforts to provide the SaaS in the quarter in which the transaction is processed and, therefore, would meet the criterion in paragraph 606-10-32-40(a). Further, XYZ concludes that allocating the amounts to each quarter would meet the allocation objective (i.e. meet the criterion in paragraph 606-10-32-40(b)) because each quarter has a consistent price structure throughout the term of the contract (see Question E280).

XYZ needs to estimate the variable amounts (and update that amount until the end of the contractual quarter) that will be earned each quarter and recognize those amounts using a time based measure of progress. If the contractual quarters are co-terminus with the entity's quarterly reporting periods, practically, XYZ could recognize the amounts as the transactions are billed and achieve the same outcome for the reporting period.

However, often times the contractual quarterly periods will not align with the entity's quarterly reporting periods. In that case, XYZ will need to estimate the transaction volumes for the contractual quarterly periods (even though XYZ will not need to estimate transaction volumes for the full one-year SaaS term) and update the estimate each reporting period. The requirement to update the estimate could result in a cumulative catch adjustment during the quarter.

Question E295

How do guaranteed minimums affect the allocation of usage-based fees within a series?

Interpretive response: It depends. It is common for SaaS providers that charge customers variable consideration in the form of usage- or transaction-based fees to require a customer to pay for a guaranteed amount of usage. For example, an entity may charge a customer $5 per transaction, but require the customer to pay for a minimum of 1,000 transactions per year. Substantive minimums represent fixed consideration.

When a performance obligation comprises a series of distinct service periods – e.g. distinct daily, monthly or annual periods of service – and a minimum is a substantive term in the contract, the entity needs to evaluate the variable consideration allocation criteria in paragraph 606-10-32-40 to determine if the amounts in excess of the minimum should be allocated to a distinct service period.

An exception exists if an entity meets the 'as-invoiced' practical expedient criteria and chooses to apply the expedient. In that case, it does not need to evaluate the variable consideration allocation guidance. *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation* (specifically, Questions F280 – F330) discusses when the as-invoiced practical expedient can be applied, including when it can be applied if the arrangement includes a minimum guarantee.

Practically, there are other scenarios when an entity may not need to evaluate the variable consideration allocation criteria because the accounting outcome would not be significantly affected. For example, when an output-based measure of progress based on usage is appropriate, applying that measure would achieve the same result as allocating the variable amounts to each period if:

- the price per use or transaction is the same for the minimum and excess quantities; and
- there are no other significant fees other than fixed fees that would be allocated to the performance obligation and recognized using the same output-based measure of progress.

If such a scenario does not exist and an entity does need to evaluate the variable consideration criteria in paragraph 606-10-32-40, the following are relevant considerations for its analysis.

Criterion (a) – Variable payment relates specifically to the entity's efforts to transfer the distinct good or service

When a contractual minimum exists, the contract will generally meet criterion (a) for the entire period covered by the contractual minimum but not for distinct periods within the larger period covered by the contractual minimum. A contract will generally meet criterion (a) for the entire period covered by the contractual minimum because the amounts in excess of the minimum relate to either the entity's efforts in transferring the distinct service, or an outcome (e.g. usage) of transferring the service over the entire contractual minimum service period. For example, when a contract has an annual minimum, any amounts in excess of the minimum during the year will generally meet criterion (a) to be allocated to the year.

However, criterion (a) will generally not be met for distinct periods within the larger period covered by the substantive contractual minimum. That is because the variable amounts are triggered only after usage in previous periods and therefore relate to the usage in the entire period rather than a specific day or month. For example, when a contract has a substantive annual minimum, any amounts in excess of the minimum will generally not meet criterion (a) to be allocated to the month when the minimum is exceeded; this is because the excess variable amounts relate to cumulative usage for all preceding months within that year.

If criterion (a) is met, the entity still needs to consider whether allocating the variable amount in excess of the minimum to a distinct good or service is consistent with the allocation objective.

Criterion (b) – Allocation is consistent with the allocation objective

To assess criterion (b), an entity needs to consider all the performance obligations and payment terms in the contract, including the minimum guaranteed amount. If allocating the amounts in excess of the minimum to one or more, but not all, distinct service periods does not reflect what an entity expects to be entitled to for those service periods, the allocation objective is not met.

In general, the same considerations discussed in Question E280 – involving whether the allocation objective has been met when allocating variable consideration to a distinct good or service in a series – apply to contracts with a minimum. In addition, the following are also relevant to the analysis of criterion (b) and are illustrated in Example E295.1 below:

— the considerations discussed in Question E300 involving whether changes in variable pricing during the contract term preclude allocating variable consideration to distinct time increments, which may apply if the minimum changes from period to period; and

— how the measure of progress used to recognize the fixed fees (including the minimum) affects the total amounts recognized in each period and whether those results are consistent with the allocation objective.

Conclusion

If both criteria are met for the period with a substantive contractual minimum, an entity allocates the variable amounts to that period and recognizes the variable amounts using the same measure of progress as the fixed fees. As a result, the entity estimates excess variable amounts for the entire contractual minimum period and recognizes those amounts over that period. However, if the contractual minimum period is a month or a quarter that does not cross reporting periods, then practically the entity will not need to estimate because the amounts will be known for the reporting period.

Example E295.1
Allocating variable consideration with a guaranteed minimum

ABC Corp. enters into a contract with Customer to provide a hosted SaaS solution for three years that is a series of distinct days of service. ABC charges Customer a usage-based fee that is considered variable consideration. In addition, ABC charges a nonrefundable upfront fee of $5,000 in exchange for set-up activities that do not transfer a good or service to the customer. ABC concludes that there is no material right as a result of the upfront fee.

ABC concludes that it cannot apply the as-invoiced practical expedient as a result of the upfront fee (see Question F290). Further, ABC concludes that a time-elapsed measure of progress is appropriate for the stand-ready performance obligation; this is because ABC expects its costs and effort of standing ready to be consistent regardless of transaction volume.

Note that ABC would recognize contractual minimums and variable fees differently than the scenarios below if an output-based measure of progress were determined to be appropriate.

Scenario 1: Annual minimum

ABC charges a usage-based fee of $5 per transaction and the contract requires Customer to pay a guaranteed minimum of 1,000 transactions for each annual period (i.e. 3,000 transactions are guaranteed for the entire contract) and this minimum is substantive. Customer's usage above 1,000 transactions in any annual period results in additional consideration of $5 per transaction to ABC.

ABC concludes that variable amounts in excess of the minimum should be allocated to the annual period in which they are earned under the contract because both variable consideration allocation criteria are met for the annual period.

— Criterion (a) in paragraph 606-10-32-40 is met for the annual period. The variable amounts relate specifically to Customer's usage of the service during the annual period because the excess amounts earned in the annual period are not dependent on transactions in a previous or future annual period.

— Criterion (b) in paragraph 606-10-32-40 is met. The allocation of excess variable amounts to the annual period in which they are earned under the contract is consistent with the allocation objective; this is because the excess amounts earned are commensurate with the benefit to Customer (i.e. transactions processed) during that annual period and the pricing is consistent in each annual period.

However, ABC cannot allocate the excess fees earned in an annual period entirely to the day, month or quarter in which the excess fees are earned under the contract because criterion (a) in paragraph 606-10-32-40 is not met with respect to those shorter periods. For example, if Customer exceeds 1,000 transactions for Year 1 in Month 9, the excess variable amounts that ABC earns under the contract in Month 10 cannot be allocated solely to Month 10; this is because those excess amounts depend on the cumulative transactions in Months 1–9.

At the beginning of each annual period in the contract, ABC estimates the variable amounts for the annual period subject to the constraint and recognizes that amount on a time-elapsed basis over the annual period. At each reporting date within an annual period, ABC reassesses its estimate of the excess variable amounts for the annual period and updates the amount recognized on a time-elapsed basis over the remainder of the annual period.

The entire fixed consideration in the contract of $20,000 (upfront fee of $5,000 + guaranteed amount of $15,000 (3,000 transactions × $5 per transaction)) is recognized on a time-elapsed basis over the three-year contract term. In any given month during the contract period, ABC recognizes 1/36th of the fixed consideration of $20,000 plus 1/12th of the estimated excess variable amounts for the respective annual period. ABC allocates changes in estimates of the excess variable amounts for an annual period evenly to each month within that annual period and recognizes a cumulative catch-up adjustment for previous months in an annual period in the month its estimate changes.

Scenario 2: Monthly minimum

Assume the same facts as Scenario 1, except that the substantive minimum is based on monthly usage of 100 transactions that resets each month – i.e. 3,600 transactions are guaranteed for the entire three-year contract.

ABC concludes that variable amounts in excess of the minimum should be allocated to each monthly period in which they are earned under the contract because both variable consideration allocation criteria are met for each monthly period.

— Criterion (a) in paragraph 606-10-32-40 is met for the monthly period. The variable amounts relate specifically to Customer's usage of the service during the monthly period because the excess amounts earned in the monthly period are not dependent on transactions in a previous or future month.

— Criterion (b) in paragraph 606-10-32-40 is met. The allocation of excess variable amounts to the monthly period in which they are earned under the contract is consistent with the allocation objective; this is because the excess amounts earned are commensurate with the benefit to Customer (i.e. transactions processed) during that month and the pricing in each period is consistent.

ABC allocates any excess variable amounts to the months in which they are earned under the contract. The entire fixed consideration in the contract of $23,000 (upfront fee of $5,000 + guaranteed amount of $18,000 (3,600 transactions × $5 per transaction)) is recognized on a time-elapsed basis over the three-year contract term.

Scenario 3: Changing minimums – allocation objective not met

Assume the same facts as Scenario 1, except that the annual minimum increases over time:

— 1,000 transactions in Year 1;
— 2,000 transactions in Year 2; and
— 3,000 transactions in Year 3.

Additionally, ABC expects at contract inception that it will process a similar amount of transactions each year (about 3,000) and does not anticipate a change in the costs of providing the service over the contract period.

ABC concludes that the variable amounts relate to the entire contract and that it cannot allocate variable amounts to the annual period in which they are earned because criterion (b) in paragraph 606-10-32-40 is not met. ABC concludes that criterion (b) is not met because each year is not priced consistently and the change in minimums over the period is not commensurate with a change in value to the customer, effort or cost.

In reaching this conclusion, ABC considered the allocation that would result from allocating variable amounts in each period along with the other consideration. ABC expects Customer's usage to be approximately 3,000 transactions each year; because fixed consideration is recognized evenly over each annual period, allocating the variable amounts to each year would result in the following amount of revenue recognized in each annual period.

Hypothetical allocation – allocation objective not met				
Annual period	**Expected usage**	**Variable amounts**	**Fixed fees recognized**	**Allocate to each annual period**
Year 1	3,000	$ 10,000[1]	$ 11,667[3]	$ 21,667
Year 2	3,000	5,000[2]	11,667[3]	16,667
Year 3	3,000	0	11,667[3]	11,667
Total	**9,000**	**$ 15,000**	**$ 35,000**	**$ 50,000**

Notes:

1. 2,000 transactions (3,000 expected usage – 1,000 minimum) × \$5/transaction.
2. 1,000 transactions (3,000 expected usage – 2,000 minimum) × \$5/transaction.
3. \$35,000 fixed fees (\$5,000 upfront fee + \$30,000 guaranteed minimum (6,000 transactions × \$5/transaction)) / 3 years.

By allocating variable amounts to the annual period in which they are earned, ABC would recognize decreasing revenue (i.e. \$21,667 in Year 1, \$16,667 in Year 2 and \$11,667 in Year 3) despite providing the same level of stand-ready service to Customer (with consistent expected costs). Therefore, ABC concludes that the allocation objective is not met.

Instead, ABC estimates total variable consideration for all three years in the contract subject to the constraint and includes that amount in the transaction price. The total transaction price (both variable and fixed) is recognized on a time-elapsed basis over the three-year contract period. At each reporting date, ABC reassesses its estimate of the excess variable amounts for the entire contract and updates the transaction price.

Scenario 4: Changing minimums – allocation objective met

Assume the same facts as Scenario 3, except that ABC expects Customer's usage to increase each year in an amount that is commensurate with the increasing annual minimums. The result in this fact pattern is different from Scenario 3 in which Customer's usage is estimated to remain constant despite increasing annual minimums.

ABC concludes that variable amounts in excess of the minimum should be allocated to the annual period in which they are earned under the contract because both variable consideration allocation criteria are met for the annual period.

- Criterion (a) in paragraph 606-10-32-40 is met for the annual period. The variable amounts relate specifically to Customer's usage of the service during the annual period because the excess amounts earned in the annual period are not dependent on transactions in a previous or future annual period.
- Criterion (b) in paragraph 606-10-32-40 is met for the annual period. While the minimums increase each year, the increase is commensurate with the expected value to the customer and expected usage. When considering all of the payment terms, ABC observes that it would recognize a consistent amount of revenue in each annual period based on expectations of usage that is commensurate with the entity's time-elapsed measure of progress.

Allocation objective <u>is</u> met				
Annual period	**Expected usage**	**Variable amounts**	**Fixed fees recognized**	**Allocate to each annual period**
Year 1	2,000	\$ 5,000[1]	\$ 11,667[4]	\$ 16,667
Year 2	3,000	5,000[2]	11,667[4]	16,667
Year 3	4,000	5,000[3]	11,667[4]	16,667
Total	**9,000**	**\$ 15,000**	**\$ 35,000**	**\$ 50,000**

Notes:

1. 1,000 transactions (2,000 expected usage – 1,000 minimum) × $5/transaction.
2. 1,000 transactions (3,000 expected usage – 2,000 minimum) × $5/transaction.
3. 1,000 transactions (4,000 expected usage – 3,000 minimum) × $5/transaction.
4. $35,000 fixed fees ($5,000 upfront fee + $30,000 guaranteed minimum (6,000 transactions × $5/transaction)) / 3 years.

Based on this conclusion, ABC:

— estimates the variable amounts subject to the constraint for each annual period in the contract at the beginning of each annual period, and recognizes that amount on a time-elapsed basis over the respective annual period;

— at each reporting date within an annual period, reassesses its estimate of the excess variable amounts for that annual period and updates the amount recognized on a time-elapsed basis over the remainder of that annual period; and

— recognizes the fixed consideration in the contract of $35,000 (upfront fee of $5,000 + guaranteed amount of $30,000 (6,000 transactions × $5 per transaction)) on a time-elapsed basis over the entire three-year contract term ($11,667 per year).

Question E300

Do other changes in the price charged per transaction or usage over the contract term preclude an entity from allocating a variable amount to the period in which it is earned?

Interpretive response: Not necessarily. SaaS arrangements that include variable fees may have rates or formulas that increase or decrease over the contract term and those changes are not based on either the entity or customer's performance (i.e. the contract price or formula changes solely on the passage of time). For example, a contract could include per transaction pricing that changes in each year – e.g. $0.10 per transaction for Year 1; $0.09 per transaction for Year 2; and $0.075 per transaction for Year 3. In contrast to volume-based discounts or rebate scenarios described in Question E290, the change in price is not dependent on either the customer's usage or the entity's performance in prior or future periods.

At the July 2015 meeting, the TRG agreed that in some facts and circumstances an entity could still allocate variable amounts entirely to the distinct service period in which it was earned when the price charged per transaction decreased each year and the change was not dependent on either the entity or customer's performance in the prior period. The TRG specifically discussed an example of IT outsourcing where the price decrease was consistent with market terms and were linked to changes in costs to fulfill the service. [TRG Agenda Paper No. 39]

There may be factors other than those discussed by the TRG – i.e. linkage to market terms or changes in cost structure – that would allow an entity to meet the allocation objective. However, entities would need evidence to support that the pricing in the period depicts the amount the entity would expect to be entitled to in exchange for transferring the distinct good or service. Therefore, together with the discussion by the TRG, the following additional factors may be helpful in assessing whether the allocation objective is met when there are changing prices or formulas:

- **Whether the change in price is commensurate with a change in value to the customer.** The market price of goods or services may change over time due to technological advances, market competition or increased efficiencies. When market prices change, the value received by the customer for the services could also change and the amount the entity expects to be entitled to for providing the services may change. Entities should support this consideration by evaluating the following (list not all inclusive):
  - **The entity's historical pricing practices and trends.** If the entity's historical pricing can demonstrate that the trends in stand-alone pricing change in a similar manner, it might indicate that the pricing reflects what the entity would expect to receive in those periods. For example, if the prices of an annual contract have decreased each year it might support a similar decrease from Year 1 to Year 2 in a two-year contract.
  - **Prices charged by competitors for similar services.** If the price decreases over time because competition in the marketplace makes the goods or services less expensive each year, it might indicate that the rates in future periods are consistent with what the entity would expect to charge for the services in the future period.
  - **The changes in price are commensurate with the changes in effort or cost of fulfilling the service.** The changes in the entity's cost could also reflect a change in market value. See the discussion below for further considerations about changes in cost or effort required to fulfill the services.
- **Whether the changes are commensurate with (or based on) a market index.** For example, when the price increases each year based on a relevant market index it would indicate that the price in each period depicts what the entity would charge in those periods. Paragraph 606-10-32-39(b) indicates that allocating a change in price based on an inflation index would be consistent with the allocation objective.
- **Whether the change in price is commensurate with the effort or cost required to fulfill the services.** When the entity's cost of performing the services decreases over time this may indicate that the price charged in future years would depict the amount the entity would expect to receive for services in those periods. For example, the TRG discussed an IT outsourcing contract where the rate charged for the activities underlying the IT service obligation reflects the increased complexity of the underlying activities that will be performed earlier in the contract period versus later in the contract period, requiring more experienced (i.e. more costly) personnel to perform the activities at the outset.

Notwithstanding the above, if the prices change because of an incentive for the customer to enter into the contract or pricing in one period reflects value attributable to another period, the allocation objective likely would not be met.

Example E300.1

Changing prices – allocation objective is met

XYZ Corp. provides a hosted software solution to customers for which customers pay a fixed upfront fee and variable amounts based on the number of transactions processed using XYZ's solution. Customers are not permitted to take possession of XYZ's software; therefore, this is a SaaS arrangement (i.e. there is no software license in the arrangement).

XYZ enters into a contract with Customer to use XYZ's solution for three years. XYZ concludes that the contract consists of a single performance obligation satisfied over time (see Question F130) of providing access to the hosted solution by Customer. XYZ also concludes that the performance obligation is a series of distinct days of service and that a time-based measure of progress is appropriate for the performance obligation (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*).

The arrangement consideration consists of a fixed upfront fee of $1,000 and a price per transaction as follows:

— Year 1 - $10 per transaction
— Year 2 - $8 per transaction
— Year 3 - $6 per transaction

The price decreases each period because XYZ is in a highly competitive market with technological advances making more technology available to its customers each year, and the entity's historical pricing trends demonstrate that pricing from comparable contracts from one year to the next change in a commensurate manner. Further, the entity's cost of providing the services continues to decrease as more customers are added to the platform that is scalable.

XYZ concludes that variable amounts per transaction should be allocated to the distinct service period (each day) in which the transaction is processed because:

— The variable amounts relate directly to the customer's usage of the SaaS. That is, the amount earned in each period is not dependent on future or past transactions.

— The allocation is consistent with the allocation objective because the price charged in Year 1, 2 and 3 depict what the entity would expect to be entitled to in those periods as demonstrated by the changes being commensurate with market trends and the entity's cost of fulfilling the service.

The fixed fee is attributable to the entire performance obligation and recognized ratably over the contract period. Because the variable amounts are allocated entirely to the periods in which they are earned, XYZ would recognize the variable fees in the months the transactions are processed.

Example E300.2

Changing prices – allocation objective is not met

Assume the same facts as Example 300.1 except that the price per transaction is as follows:

- Year 1 - $5 per transaction
- Year 2 - $10 per transaction
- Year 3 - $8 per transaction

XYZ offered Customer a significant discount on the transaction-based pricing in the first year as an inducement to enter into the contract and then charges the customer an amount higher than what it normally charges in Year 2 and Year 3 in order to recover some of the shortfall in Year 1.

XYZ concludes that variable amounts per transaction should not be allocated to the distinct service period (each day or the year) in which the transaction is processed. While the variable amounts relate specifically to the customer's usage of the SaaS (i.e. the criterion in paragraph 606-10-32-40(a) is met because the amount earned in each period is not dependent on future or past transactions), allocating the transaction-based fees to each day is inconsistent with the allocation objective (i.e. the criterion in paragraph 606-10-32-40(b) is *not* met). That is because XYZ priced the first year significantly below what it would price similar services to its customers and Year 2 and Year 3 are incremental to what the entity would normally charge customers in future periods. This pricing structure indicates that some of the price in Year 2 and Year 3 relates to services provided in Year 1. As such, allocating the fees based on the contractual rates would not be consistent with the allocation objective because the amounts per transaction do not depict the amount the entity would expect to receive for providing those distinct services.

XYZ would estimate the transaction price for the entire three-year period, which would include the fixed fees and the total transaction-based fees and recognize the transaction price ratably over the three-year period. XYZ would be required to update the transaction price each period and make corresponding adjustments to the transaction price and the revenue recognized.

Example E300.3

Per user pricing – allocation objective is met

BB Corp. provides a hosted software solution to customers for which customers pay a monthly fee based on the number of distinct users that log into the system each month. Customers are not permitted to take possession of BB's software.

BB enters into a contract with Customer Y to use its solution for three years. BB is required to perform significant set-up activities that do not provide an incremental benefit to Customer Y and are not a promised good or service in the contract (see Question C220). BB also charges a fixed monthly fee.

BB concludes that the user-based provision is variable consideration rather than an option to acquire incremental services. That is because the user-based fee merely describes how the customer will compensate BB for the single service. BB also considered the following based on Questions C390 and C400:

— Customer Y does not have to obtain anything incremental from BB for each user.

— Customer Y is not required to execute an additional contract for each user.

— Customer Y does not need to make an incremental request for each user.

— The number of users or change in number of users does not create an additional or new obligation for the remainder of the term. Rather it resets each month and Customer Y has the same obligation each month regardless of the number of users.

— An additional user does not create an incremental right that increases the overall capabilities of the solution. That is, Customer Y's rights and ability to derive benefit from access to the hosted solution are the same each month.

The per user per month fee changes during the three-year term as follows:

— Year 1 - $8 per user
— Year 2 - Year 1 price × (lesser of 1.03 of Year 1 pricing or 1+ increase in consumer price index)
— Year 3 - Year 2 price × (lesser of 1.03 of Year 2 pricing or 1+ increase in consumer price index)

BB concludes that the per user amounts should be allocated entirely to each month because:

— the variable amounts relate directly to the customer's usage of the service in that time period and meet the criterion in paragraph 606-10-32-40(a); and

— the allocation is consistent with the allocation objective because the price charged in each month depicts the amount the entity would charge for those services in those periods. While the price increases each year, because that amount is based on an inflation index the change is commensurate with the market value for the services.

Example E300.4

Per user pricing – allocation objective is not met

Assume the same facts as Example E300.3 except the following:

BB is required to perform significant set-up activities that do not provide an incremental benefit to Customer Y and are not a promised good or service in the contract (see Question C220). BB incurs significant costs for these efforts and prices its subsequent services in a manner in which it expects to recover the costs in the first year of service. BB and its competitors typically do not charge customers separately for the set-up activities and price those costs into the first year of service. BB also charges a fixed monthly fee.

The per user per month fee changes during the three-year term and is as follows:

— Year 1 - $10 per user
— Year 2 - $8 per user
— Year 3 - $8 per user

BB concludes that the per user amounts should not be allocated entirely to each month. While the variable amounts relate directly to the customer's usage of the service, allocating the transaction-based fees to each day is inconsistent with the allocation objective.

While the pricing is consistent with its customary pricing practices and relates to recovering the set-up costs, BB concludes that the change in price from Year 1 to Year 2 is not commensurate with changes in value or efforts in fulfilling the services transferred to the customer (e.g. the hosted application). The per user fees in Year 1 would not depict the amount the entity would normally charge because the amount is incremental to what it would normally charge for those services. BB would not consider the cost of the set-up activities because those are not a fulfillment cost of the distinct service to which it would allocate the fee. In other words, the set-up activities do not justify the incremental Year 1 fee because they do not transfer a good or service to the customer. The value to the customer of the service is the same each year of the three-year term.

BB would estimate the transaction price for the entire three-year period and recognize the transaction price based on an appropriate measure of progress.

Question E310

Can the allocation objective be met if zero consideration is allocated to a performance obligation?

Interpretive response: No. Allocating zero consideration to a performance obligation would not be consistent with the allocation objective. This view is consistent with the FASB view that an allocation of the transaction price should not result in an allocation of zero to a performance obligation because, by definition, a distinct good or service must have value to the customer on a stand-alone basis. See Question E170.

In order to meet the allocation objective, an entity needs to consider all of the payment terms and performance obligations in the contract. Therefore, the evaluation could become more complex in scenarios that involve multiple performance obligations.

For example, if an entity had a contract with two performance obligations (e.g. software-as-a-service and implementation services) but only charged a variable amount based on usage of one of the performance obligations (e.g. a transaction-based fee for the SaaS), it would be inappropriate to allocate the variable amounts entirely to only the one performance obligation on which the variable amount is based.

Example E310.1
Upfront professional services and SaaS

ABC Corp. provides a hosted software solution to customers for which customers generally pay a usage-based fee based on the number of transactions processed. Customers are not permitted to take possession of ABC's software. ABC and Customer enter into a contract for Customer to use ABC's SaaS for three years and charges $10 per transaction processed.

As part of the contract, ABC agrees to perform professional services before Customer goes live with ABC's hosted solution. ABC concludes the contract contains two performance obligations: the SaaS and the professional services (see Question C280), both of which are satisfied over time (see Questions F130 and F190). ABC also concludes that the SaaS is a single performance obligation that is composed of a series of distinct daily service periods. ABC typically charges $100 per hour for professional services and estimates the upfront professional services will take 200 hours to complete. ABC charges similar customers $10 per transaction for its hosted solution when sold separately.

ABC must evaluate whether the variable amounts should be allocated entirely to one or more, but not all, of the performance obligations in the contract. Even though the per transaction amounts relate specifically to the usage of the hosted solution (i.e. the criterion in paragraph 606-10-32-40(a) is met), ABC concludes the allocation objective is not met (i.e. the criterion in paragraph 606-10-32-40(b) is *not* met) because a reasonable amount of consideration would not be allocated to the professional services. As a result, ABC allocates the transaction price to the performance obligations on a relative stand-alone selling price basis.

ABC estimates that the stand-alone selling price of the professional services is $20,000 ($100 per hour × 200 estimated hours) and $180,000 ($10 per transaction × 18,000 estimated number of transactions) for the hosted solution (i.e. that is, the price charged per transaction is consistent with prices charged to similarly-situated customers on a stand-alone basis). ABC estimates a transaction price of $180,000 ($10 × 18,000 estimated transactions) and concludes the amount does not need to be constrained because of extensive experience with other significant contracts and the likelihood of a significant reversal is diminished because the performance obligation is satisfied over time (see Question D180).

At contract inception, ABC allocates the transaction price as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Transaction price allocation
Professional services	$ 20,000	10%	$ 18,000
SaaS	180,000	90%	162,000
Total	**$200,000**	**100%**	**$180,000**

ABC would recognize the $18,000 as it satisfies its performance obligation for the professional services over time. After the professional services are completed, but before the SaaS period begins, ABC would have recorded the following cumulative amounts:

	Debit	Credit
Contract asset	18,000	
Revenue – professional services		18,000

ABC would also evaluate whether the variable amounts allocated to the SaaS performance obligation – that is 90% of each dollar of variable consideration – can be further allocated to the distinct service periods to which the variable amount relates. ABC concludes that the requirements to allocate the variable consideration are met because the variable amounts relate specifically to Customer using the SaaS and allocating the remaining variable amounts to each day would be consistent with the allocation objective because ABC typically prices similar services on a similar per transaction basis and the amounts are consistent across the contract period.

As a result, as each transaction is processed, 10% of the consideration reduces the contract asset and 90% is allocated to the distinct service period and recognized as revenue. If the estimated transaction price changes, ABC would only adjust the amount recognized for professional services because changes in variable amounts for the SaaS would be allocated entirely to the period in which the variability was resolved in accordance with paragraph 606-10-32-44. That is, the variable amounts allocated to the SaaS are allocated to the distinct period in which the transaction is processed and a change in transaction price (based on estimated number of transactions) would similarly be allocated to the distinct period the transaction is processed.

Year 1

Customer processed 8,000 transactions and ABC billed Customer $80,000. ABC records the following amounts.

	Debit	Credit
Accounts receivable	80,000	
Contract asset		8,000[1]
Revenue – SaaS		72,000[2]

Notes:
1. $80,000 × 10%.
2. $80,000 × 90%.

At the end of Year 1, ABC adjusts its estimate of the transaction price to $200,000 because it anticipates processing 2,000 more transactions than originally estimated. As a result, ABC allocates 10% of the change to the professional services in accordance with the relative allocation established at contract inception. ABC records the following amounts.

	Debit	Credit
Contract asset	2,000	
Revenue – professional services		2,000[1]

Note:
1. (($200,000 × 10%) – $18,000).

Year 2

Customer processed 9,000 transactions resulting in additional billings of $90,000. ABC records the following amounts.

	Debit	Credit
Accounts receivable	90,000	
Contract asset		9,000[1]
Revenue – SaaS		81,000[2]

Notes:
1. $90,000 × 10%.
2. $90,000 × 90%.

At the end of Year 2, ABC adjusts its estimate of the transaction price to $240,000 because it anticipates processing 4,000 more transactions than its previous estimate. ABC concludes that because both performance obligations have already been allocated an amount of consideration equal to its stand-alone selling price at contract inception that the excess variable consideration should be allocated entirely to the SaaS in accordance with paragraph 606-10-32-40 as it relates specifically to Customer's usage of that service and the per transaction price is consistent with a per transaction stand-alone selling price. As a result, the change in estimate does not affect revenue previously recognized but only the period the variable amount is allocated to in the future.

Year 3

Customer processed the remaining 7,000 transactions and ABC billed Customer $70,000. ABC records the following amounts.

	Debit	Credit
Accounts receivable	70,000	
Contract asset		3,000[1]
Revenue – SaaS		67,000[2]

Notes:
1. $20,000 – $8,000 – $9,000.
2. $70,000 – $3,000.

Alternative approach

The example above illustrates just one approach and is dependent upon facts and circumstances and the appropriate application of judgment. Other approaches may be acceptable if it can be demonstrated that they are consistent with the allocation objective. In the example above, if the stand-alone selling prices for the professional services and the SaaS, a daily stand-ready obligation, were ranges, then it may be less apparent that the excess variability in transaction price should be allocated entirely to the SaaS. Consequently, in situations where the stand-alone selling prices are ranges, an entity might estimate the total discount in the contract ($20,000 of the 'free' implementation services) and allocate that amount on a relative basis between the performance obligations using the most recent estimate of volumes to be processed. Under this approach, in each period an entity would update its estimate of the total expected per transaction fees and allocate the discount on a proportionate basis between the professional services and SaaS.

Under both approaches, changes in the transaction price would be allocated to the period the transactions are processed in accordance with paragraph 606-10-32-40. Any change is a result of a change in estimate rather than a change in pricing that is dependent upon past or future purchase (i.e. the change is not a result of tiered pricing, rebates or discounts). Said differently, changes in estimates of the transaction price are allocated in the same manner as the original allocation in accordance with paragraph 606-10-32-43 and 32-44.

Under both approaches the entity would initially allocate $18,000 to implementation and the remaining amount to SaaS and the following illustrates the accounting from that point forward.

Year 1

Customer processed 8,000 transactions and ABC billed Customer $80,000. ABC records the following amounts.

	Debit	*Credit*
Accounts receivable	80,000	
Contract asset		8,000[1]
Revenue – SaaS		72,000[2]

Notes:
1. $80,000 × 10%.
2. $80,000 × 90%.

ABC adjusts its estimate of the transaction price to $200,000 because it anticipates processing 2,000 more transactions than originally estimated. As a result, ABC re-allocates the discount based on the updated transaction price. The $20,000 discount is allocated to the SaaS as follows [$20,000 × ($200,000 ÷ $220,000)] = $18,181. As a result, the entity would allocate $181,819 ($200,000 – $18,181) to the SaaS and $18,181 to the professional services. ABC would adjust the professional services as follows.

	Debit	*Credit*
Contract asset	181[1]	
Revenue – professional services		181

Note:
1. $18,181 – $18,000.

Year 2

Customer processed 9,000 transactions resulting in additional billings of $90,000. ABC records the following amounts.

	Debit	*Credit*
Accounts receivable	90,000	
Contract asset		8,182[1]
Revenue – SaaS		81,818[2]

Notes:
1. $90,000 × ($20,000 ÷ $220,000).
2. $90,000 × ($200,000 ÷ $220,000).

ABC adjusts its estimate of the transaction price to $240,000 because it anticipates processing 4,000 more transactions than its previous estimate. As a result, ABC reallocates the discount based on the updated transaction price. The $20,000 discount is allocated to the SaaS as follows [$240,000 × ($20,000 ÷ $260,000)] = $18,461. As a result, the entity would allocate $221,539 to the SaaS ($240,000 – $18,461) and $18,461 to the implementation services. ABC would adjust the implementation services revenue as follows.

	Debit	*Credit*
Contract asset	280[1]	
Revenue – Professional Services		280

Note:
1. $18,461 – $18,181.

Year 3

Customer processed the remaining 7,000 transactions and ABC billed the customer $70,000. ABC records the following amounts.

	Debit	*Credit*
Accounts receivable	70,000	
Contract asset		2,279[1]
Revenue – SaaS		67,721[2]

Notes:
1. $18,461 – $8,000 – $8,182.
2. $70,000 – $2,279.

Example E310.2

Upfront professional services and SaaS – tiered pricing

ABC Corp. provides a hosted software solution to customers for which customers generally pay a usage-based fee based on the number of transactions processed. Customers are not permitted to take possession of ABC's software. ABC and Customer enter into a contract for Customer to use ABC's SaaS for three years and charges the following per transaction amount that resets each year.

Quantity processed	Price per transaction
0-1,000	$10
1,001-5,000	$ 8
> 5,000	$ 6

As part of the contract, ABC agrees to perform professional services before Customer goes live with ABC's hosted solution. ABC concludes the contract contains two performance obligations: the SaaS and the professional services (see Question C280), both of which are satisfied over time (see Questions F130 and F190). ABC also concludes that the SaaS is a single performance obligation that is comprised of a series of distinct daily service periods and the usage-based fee is variable consideration.

ABC typically charges $100 per hour for professional services and estimates the professional services will take 200 hours to complete. ABC charges similar customers the same per transaction pricing for its hosted solution when sold separately.

ABC must evaluate whether the variable amounts should be allocated entirely to one or more, but not all, of the performance obligations in the contract. Even though the per transaction amounts are calculated based on the usage of the hosted solution, ABC concludes the allocation objective is not met because a reasonable amount of consideration would not be allocated to the professional services. As a result, ABC allocates the transaction price to the performance obligations on a relative stand-alone selling price basis.

ABC concludes that the stand-alone selling price of the professional services is $20,000 ($100 per hour × 200 estimated hours) and $180,000 for the hosted solution. The pricing structure is consistent with prices charged to similarly situated customers on a stand-alone basis, and ABC estimates the stand-alone selling price for the hosted solution based on an estimate of 8,000 transactions processed in each year or $60,000 per annual period as follows.

Quantity processed	Price per transaction	Per year	Total price
0-1,000	$10	1,000	$10,000
1,001-5,000	$ 8	4,000	32,000
> 5,000	$ 6	3,000	18,000
Total		**8,000**	**$60,000**

ABC estimates a transaction price of $180,000 ($60,000 per year × 3 years) and concludes the amount does not need to be constrained because of extensive experience with other significant contracts and the likelihood of a significant reversal is diminished because the performance obligation is satisfied over time (see Question D180).

At contract inception, ABC allocates the transaction price as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Transaction price allocation
Professional services	$ 20,000	10%	$ 18,000
SaaS	180,000	90%	162,000
Total	**$200,000**	**100%**	**$180,000**

ABC would recognize the $18,000 as it satisfied its performance obligation for the professional services. After the professional services are completed, but before the SaaS period begins, ABC records the following entry.

	Debit	*Credit*
Contract asset	18,000	
Revenue – professional services		18,000[1]

Note:
1. $180,000 × 10%.

ABC would also evaluate whether the variable amounts allocated to the SaaS performance obligation – that is 90% of each dollar of variable consideration -- can be further allocated to the distinct service periods to which the variable amount relates. ABC concludes that the requirements to allocate the variable consideration to each day/month are not met because the variable amounts relate specifically to an entire annual period due to the tiered pricing (see Question E290).

ABC next evaluates whether the variable amounts allocated to the SaaS performance obligation can be allocated entirely to the annual period to which it relates. ABC concludes that the fee relates specifically to the annual periods and that allocating the variable amount to each *annual* period is consistent with the allocation objective because ABC typically prices similar services on a similar basis and the pricing structure is consistent in each annual period.

As a result, ABC would estimate the number of transactions that would be processed in each annual period and recognize that amount over each annual period based on an appropriate measure of progress. If the estimated transaction price changes, ABC would adjust the amount recognized for professional services. Further, for the portion of the change in transaction price related to a change in the expected number of transactions in the current annual period, the entity would make an adjustment to revenue recognized for the SaaS. However, for any portion of the transaction price change related to an estimate of transactions to be processed in future annual periods, the entity would only make an adjustment to amounts recognized for professional services because the portion related to the SaaS is allocated entirely to the period in which the variability was resolved.

Year 1

ABC concludes that a time-elapsed measure of progress is appropriate for the SaaS performance obligation and recognizes the $54,000 allocated to the first year ratably over the first year. At the end of June of Year 1, ABC adjusts its estimate of transactions to be processed in each year to 9,000 transactions or $66,000 per year. As such, the total transaction price increased to $198,000.

ABC records the following amount of revenue for the first half of Year 1 and adjustment to professional services (for which $18,000 had already been recognized) based on the change in transaction price.

	Debit	*Credit*
Contract asset	31,500	
Revenue – professional services		1,800[1]
Revenue – SaaS		29,700[2]

Notes:
1. ($198,000 × 10%) – $18,000.
2. (($198,000 × 90%) ÷ 3) × 50%.

Through the first six months, Customer had processed 5,000 transactions and ABC billed Customer $42,000 (1,000 × $10 + 4,000 × $8). ABC records the following amounts.

	Debit	*Credit*
Accounts receivable	42,000	
Contract asset		42,000

At the end of Year 1, Customer has processed an additional 4,000 transactions billed the customer $24,000 (4,000 × $6) and ABC records the following amounts.

	Debit	*Credit*
Accounts receivable	24,000	
Contract asset	5,700	
Revenue – SaaS		29,700[1]

Note:
1. ((($198,000 × 90%) ÷ 3) × 100%) – $29,700.

Year 2

Customer processed 9,000 transactions resulting in additional billings of $66,000. ABC records the following amounts as of the end of the year.

	Debit	*Credit*
Accounts receivable	66,000	
Contract asset		6,600[1]
Revenue – SaaS		59,400[2]

Notes:
1. $66,000 × 10%.
2. $66,000 × 90%.

Year 3

Customer processed the remaining 9,000 transactions and ABC billed Customer $66,000. ABC records the following amounts as of the end of the year.

	Debit	*Credit*
Accounts receivable	66,000	
Contract asset		6,600[1]
Revenue – SaaS		59,400[2]

Notes:

1. $66,000 × 10%.
2. $66,000 × 90%.

Question E320

Can variable consideration be allocated entirely to one performance obligation and fixed consideration be allocated entirely to another performance obligation?

Interpretive response: Yes, provided the criteria to allocate the variable consideration entirely to a single performance obligation are met.

In contrast to the discussions in Questions and Examples in E280 through E300, when the contract has multiple performance obligations, the entity needs to consider whether the allocation objective is met with respect to all of the performance obligations in the contract. As such, the entity will need to evaluate whether allocating variable fees entirely to one performance obligation would result in amounts allocated to each performance obligation that would reasonably depict the amount of consideration that the entity expects for satisfying that performance obligation.

Example 35 Case A in Topic 606 (paragraphs 606-10-55-271 through 55-274) illustrates a fact pattern where variable consideration is allocated entirely to one performance obligation and the remaining fixed consideration is allocated entirely to another performance obligation. In that example, the fixed amount of consideration approximated the stand-alone selling price of one performance obligation and the variable amounts approximated the stand-alone selling price of another performance obligation.

In contrast, Example 35 Case B (paragraphs 606-10-55-275 through 55-279) illustrates a fact pattern where the variable amounts could not be allocated entirely to a single performance obligation because it would have resulted in more than stand-alone selling price allocated to one performance obligation and less than stand-alone selling price being allocated to the other performance obligation.

As discussed in Question E260, the entity first applies the guidance on allocating variable consideration and then allocates the remaining consideration. However, the evaluation of whether the allocation objective is met should consider the resulting allocation of both the fixed and variable consideration in the contract.

Based on Example 35, when the variable prices are incremental to what the entity would normally charge for that performance obligation it would indicate that the variable amounts relate to more than one performance obligation and should not be allocated entirely to one performance obligation. However, if the variable amounts were equal to or less than the price the entity would normally charge for a performance obligation the variable amounts could still be entirely allocated to a single performance obligation if the allocation of the other consideration in the contract reflects a reasonable allocation for the entire contract. For example, if a contract with two performance obligations included transaction-based fees at a price per transaction less than the price normally charged and fixed fees that were incremental to the stand-alone selling price of the other performance obligation, allocating the variable amount entirely to one performance obligation and the fixed consideration between the two performance obligations may be consistent with the allocation objective.

Example E320.1

Variable consideration allocated entirely to one performance obligation in the contract

ABC Corp. provides a hosted software solution to customers for which customers generally pay a usage-based fee based on the number of transactions processed. Customers are not permitted to take possession of ABC's software. ABC and Customer enter into a contract for Customer to use ABC's SaaS for three years and charges $10 per transaction processed and a fixed upfront fee of $20,000.

As part of the contract, ABC agrees to perform professional services before Customer goes live with ABC's hosted solution. ABC concludes the contract contains two performance obligations: the SaaS and the professional services, both of which are satisfied over time. ABC also concludes that the SaaS is a single performance obligation that is composed of a series of distinct daily service periods. However, the professional services are not a series.

ABC estimates that the stand-alone selling price of the professional services is $20,000. ABC charges similar customers $10 per transaction for its hosted solution on a stand-alone basis.

ABC allocates the variable fees entirely to the SaaS because:

— the variable payment relates specifically to Customer's usage of the SaaS; and
— allocating the variable amounts charged entirely to the SaaS and the fixed amount to the professional services would depict what the entity would expect to be entitled to for each service on a stand-alone basis.

ABC allocates the fixed amounts entirely to the professional services and recognizes that amount as it satisfies the performance obligation. The variable amounts are allocated to the SaaS performance obligation. ABC could either apply the practical expedient to recognize the variable amounts as the entity has the right to bill (see *Chapter F – Step 5: Recognize revenue when (or as) the* *entity satisfies a performance obligation*) or allocate the fees to each distinct service period. Either would provide the same result.

Example E320.2

Fixed consideration allocated to multiple performance obligations and variable consideration allocated entirely to one performance obligation

Consider the same facts as Example E320.1 except that:

— The price stated in the contract for professional services is a fixed amount of $30,000 while stand-alone selling price is $20,000.
— The price stated in the contract for the transaction-based fees is $9 per transaction processed while it normally charges similar customers $10 per transaction on a stand-alone basis.

ABC estimates that it will be entitled to variable consideration of $90,000 based on its estimate of processing 10,000 transactions. On an absolute dollar basis, the estimated stand-alone selling price of the SaaS is $100,000 ($10 per transaction × 10,000 estimated transactions). The difference between the discounted variable amounts ($90,000) and the estimated stand-alone selling price is $10,000.

ABC allocates the variable fees entirely to the SaaS because:

— the variable payments relate specifically to usage of the SaaS; and

— allocating the variable amounts charged for the SaaS would be consistent with the allocation objective because the allocation of the fixed consideration to both the SaaS and the professional services would depict the amounts the entity would expect to receive and normally charge for the SaaS and the professional services.

After the allocation of variable consideration, ABC allocates the fixed consideration. The fixed consideration would be allocated based on the general guidance that requires a relative stand-alone selling price allocation. However, in order to be consistent with the allocation objective, ABC would reduce the stand-alone selling price of the SaaS by the estimated variable consideration allocated to the SaaS. In this example, the stand-alone selling price of the SaaS is $100,000, which would be reduced to $10,000 by the estimate of $90,000 of variable consideration allocated to the SaaS. As such, the fixed consideration of $30,000 would be allocated as follows:

— $20,000 to professional services [$20,000 ÷ ($20,000 + $10,000) × $30,000]
— $10,000 to SaaS [$10,000 ÷ ($20,000 + $10,000) × $30,000]

Question E330

If a contract contains different types of variable consideration, does all of the variable consideration need to be allocated in the same manner?

Interpretive response: No. An entity should apply the guidance to each type of variable consideration within a contract. It is common to have multiple variable payment streams in an individual contract. Depending on the facts and circumstances, an entity could conclude that some variable amounts meet the requirements to be allocated to one or more, but not all, distinct goods or services while other variable amounts in the same contract are attributable to all of the distinct goods or services.

For example, at the July 2015 meeting, the TRG discussed a fact pattern involving hotel management services with several variable payment streams and agreed that different payments could be allocated to different parts of the contract. In that example, a multi-year contract for daily distinct services included annual performance bonuses, monthly variable fees based on hotel occupancy and daily reimbursements of costs to fulfill the contract. The TRG agreed that in the fact pattern described, allocating the performance bonus to the annual period (i.e. the bonus would be recognized over the entire period), the monthly occupancy fees entirely to each month and daily cost reimbursements to each day would meet the requirements in paragraph 606-10-32-40. [TRG Agenda Paper No. 39]

Example E330.1 illustrates a SaaS example with multiple variable payment streams allocated to an annual period.

Example E330.1

Multiple variable payments in one contract allocated to the period they were earned

XYZ Corp. provides a hosted software application to customers and charges variable amounts based on the number of users each month, which varies and is measured on a resetting basis each month. XYZ concluded that the user-based provision is variable consideration rather than an option to acquire incremental services. That is because the user-based fee merely describes how the customer will compensate XYZ for the single service (see Questions C390 and C400 and Example C390.2). Customers are not permitted to take possession of XYZ's software.

XYZ enters into a contract with Customer A to use XYZ's application for one year. XYZ charges $5 per month for each user. The number of users that will access the application during the contract term is not known.

The contract also has a service level agreement (SLA) under which XYZ warrants that the hosted application will be available and functioning to specifications during the service period at least 99% of the time (i.e. the maximum percentage of down-time for maintenance or due to increased network traffic will be one percent). In any quarter that the downtime is greater than 1%, Customer will be entitled to a 10% credit of that quarter's fees against the next month's payment. XYZ concludes that the SLA is variable consideration (see Question D170 for further details).

XYZ concludes that the contract consists of a single performance obligation satisfied over time of providing access to the hosted solution to Customer A. XYZ also concludes that the performance obligation is a series of distinct days of service and that a time-based measure of progress is appropriate for the performance obligation (see Question F240).

XYZ concludes that the contract has two types of variable consideration, the monthly per user fees and the SLA. As such, XYZ evaluates whether those amounts should be allocated entirely to one or more distinct service periods.

XYZ first evaluates the monthly per user fee. XYZ concludes that the per user amounts should be allocated entirely to each month. The variable amounts relate directly to the customer's usage of the service in that time period and meet the criterion in paragraph 606-10-32-40(a). Further, the price per user is consistent each month and would depict the amount the entity would charge to provide those services on a monthly basis.

XYZ then evaluates the SLA. XYZ concludes the SLA relates directly to its efforts or an outcome based on its performance in each quarter because the refund is attributed to its failure to provide the level of service promised in the contract. As such, XYZ concludes the SLA should be allocated to each quarter rather than each month because the SLA is based on its cumulative performance in a quarter.

XYZ then evaluates whether allocating the SLA to each quarter would be consistent with the allocation objective. XYZ concludes that allocating the SLA to each quarter would be consistent with the allocation objective when considering that the formula ascribed to each quarter is consistent from period to period and would depict what XYZ would expect to be entitled to in exchange for that level of performance each quarter.

XYZ not only needs to consider the allocation of the payments individually but it must also consider the allocation of all of the payment terms. As such, because the per user fee and SLA relate to different service periods, XYZ needs to consider whether allocating the fees to different periods is consistent with the allocation objective. XYZ concludes that allocating the per user fee and SLA to different periods is consistent with the allocation objective because each month in a quarter is in effect allocated its proportion (i.e. one-third of the quarterly amount recognized) of the SLA and the amount allocated to each month depicts a per user fee reduced by any service level penalties. XYZ notes this conclusion is consistent with the TRG discussion and that the SLA is akin to a performance bonus (although structured as a penalty) and the per user fee is similar to a monthly occupancy fee.

Question E335

How does an entity evaluate the variable consideration allocation guidance for a series of distinct quantities?

Interpretive response: When a single performance obligation consists of a series of distinct quantities, the entity evaluates the criteria to allocate variable consideration to one or more, but not all distinct goods or services in a contract (Allocating variable consideration section in this chapter) to determine if it may allocate variable fees to each quantity rather than a time period.

For example, if a performance obligation consists of a promise to process 25 transactions rather than a series of distinct time periods (i.e. the service is not a stand-ready obligation), the entity evaluates whether it may allocate any variable amounts to each transaction instead of a time period.

Example E335.1

Variable consideration allocated in a series of distinct quantities

ABC Co. enters into a contract with Customer to process one transaction each month for the following year using its SaaS platform. ABC charges the customer 5% of the total dollar amount processed in each transaction.

ABC concludes that the contract has a single performance obligation consisting of a series of distinct services and that the nature of the promise is to process 12 transactions rather than a service of standing ready (see *Chapter C – Step 2: Identify the performance obligations in the contract*). Further, because the ultimate amount of consideration to be received is unknown, the contract has variable consideration.

ABC concludes that it should allocate the variable fees entirely to each transaction as it occurs because:

- the variable payment relates specifically to each transaction and the amount is not dependent on past or future transactions; and
- allocating the variable amounts to the transaction would depict what the entity expects to be entitled to for each on a stand-alone basis because each transaction is priced the same (i.e. the formula is the same) throughout the contract period and the changes in the dollar amount reflect the additional value to the customer for processing larger or smaller transactions.

Question E340

Can a significant financing component be allocated entirely to one or more, but not all, performance obligations?

Interpretive response: Yes, in some cases. At the March 2015 meeting, the TRG agreed that in some circumstances a significant financing component (if one is deemed to exist – see Questions D230 – D340) could be allocated to one or more, but not all, of the performance obligations in the contract. This is a different question from that in Question D310, which concludes that, for purposes of determining *whether a significant financing component exists*, an entity will generally allocate each payment received to all of the performance obligations in the contract on a pro rata basis to calculate the financing component and determine whether the practical expedient applies.

Topic 606 only provides examples of a significant financing component in contracts with a single performance obligation; therefore, it was unclear if a significant financing component could be allocated entirely to one or more, but not all, performance obligations. The TRG generally agreed that allocating a significant financing component entirely to one or more performance obligations may be consistent with the allocation objective in some cases. While no specific conclusions were reached by the TRG on when this would be appropriate, the FASB and IASB staffs indicated (in TRG Agenda Paper No 30 from that March 2015 meeting) that the considerations about whether a significant financing component can be allocated entirely to one or more, but not all, of the performance obligations in a contract may be similar to those an entity considers in determining whether variable consideration or a bundled discount relates to only one or some of the performance obligations in a contract, but not all.

Question E345

Can fixed consideration be allocated to one or more, but not all, distinct goods or services within a series?

Interpretive response: No. Fixed consideration cannot be allocated among the distinct goods or services within a single performance obligation (a series) using the variable consideration allocation guidance.

Instead, the fixed consideration allocated to the entire performance obligation is attributed to the distinct goods or services based on the single measure of progress (e.g. time-elapsed method, input method) used to determine progress toward complete satisfaction of the performance obligation. A measure of progress might approximate the effect of allocating fixed consideration to portions of a series. For guidance on measuring progress, see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*.

Question E346

If a nonrefundable upfront fee relates to a separate performance obligation, should it be allocated entirely to that performance obligation?

Interpretive response: Not necessarily. Even when a nonrefundable upfront fee relates to a separate performance obligation, the amount of the fee may not equal the relative stand-alone selling price of that performance obligation. Therefore, some of the fee could be allocated to other performance obligations in the contract.

See Question E210 for further discussion on allocating the transaction price to performance obligations when the sum of stand-alone selling prices in a contract is less than the total transaction price.

Changes in the transaction price

Excerpt from ASC 606-10

> Changes in the Transaction Price

32-42 After contract inception, the **transaction price** can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

32-43 An entity shall allocate to the **performance obligations** in the contract any subsequent changes in the transaction price on the same basis as at **contract** inception. Consequently, an entity shall not reallocate the transaction price to reflect changes in **standalone selling prices** after contract inception. Amounts allocated to a satisfied performance obligation shall be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

32-44 An entity shall allocate a change in the transaction price entirely to one or more, but not all, performance obligations or distinct goods or services promised in a series that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) only if the criteria in paragraph 606-10-32-40 on allocating variable consideration are met.

32-45 An entity shall account for a change in the transaction price that arises as a result of a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. However, for a change in the transaction price that occurs after a contract modification, an entity shall apply paragraphs 606-10-32-42 through 32-44 to allocate the change in the transaction price in whichever of the following ways is applicable:

a. An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 606-10-25-13(a).

b. In all other cases in which the modification was not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

After contract inception, the transaction price may change for various reasons – including the resolution of uncertain events or other changes in circumstances that affect the amount of consideration to which an entity expects to be entitled. In most cases, these changes are allocated to performance obligations on the same basis as at contract inception. For example, when using the relative stand-alone selling price method any change in the transaction price is similarly allocated on a proportional basis. Similarly, when variable consideration is allocated entirely to one or more, but not all, performance obligations or distinct goods or services that comprise a single performance obligation in accordance with paragraph 606-10-32-40, any changes in those variable amounts are allocated to those performance obligations or distinct goods or services. Any portion of a change in transaction price that is allocated to a satisfied or partially satisfied performance obligation is recognized as revenue – or as a reduction in revenue – in the period of the transaction price change.

A change in the transaction price resulting from a contract modification requires special consideration. When the change in the transaction price is a result of a modification (i.e. the modification results in a change in the contractual price promised in the contract), the transaction price is allocated in accordance with the modification guidance (see *Chapter G – Contract modifications*). When the change in transaction price occurs *after* a contract modification, the change is allocated to the performance obligations in the modified contract – i.e. those that were unsatisfied or partially unsatisfied immediately after the modification – unless the:

- change is attributable to an amount of variable consideration that was promised before the modification; and
- the modification was accounted for as a termination of the existing contract and creation of a new contract.

How an entity allocates changes in the transaction price after a modification depends on whether the change is attributable to variable amounts promised before the modification. That is because a change in the expected amount of variable consideration and changes in the transaction price arising from a modification are the results of different economic events. A change in the expectation of variable consideration relates to a resolution of variable consideration identified and agreed upon at contract inception, whereas a change in price arising from a modification is the result of a separate and subsequent negotiation between the two parties. As such, it may be appropriate to allocate changes in variable consideration that was promised before the modification to distinct goods or services that have been satisfied even if the modification is accounted for on a prospective basis as a termination of an existing contract and creation of a new contract. [ASU 2014-09.BC82]

The following example in Topic 606 illustrates a scenario where the transaction price changes after a contract modification.

Excerpt from ASC 606-10

>> Contract Modifications

>>> Example 6—Change in the Transaction Price after a Contract Modification

55-117 On July 1, 20X0, an entity promises to transfer two distinct products to a customer. Product X transfers to the customer at contract inception and Product Y transfers on March 31, 20X1. The consideration promised by the customer includes fixed consideration of $1,000 and variable consideration that is estimated to be $200. The entity includes its estimate of variable consideration in the transaction price because it concludes that it is probable that a significant reversal in cumulative revenue recognized will not occur when the uncertainty is resolved.

55-118 The transaction price of $1,200 is allocated equally to the performance obligation for Product X and the performance obligation for Product Y. This is because both products have the same standalone selling prices and the variable consideration does not meet the criteria in paragraph 606-10-32-40 that requires allocation of the variable consideration to one but not both of the performance obligations.

55-119 When Product X transfers to the customer at contract inception, the entity recognizes revenue of $600.

55-120 On November 30, 20X0, the scope of the contract is modified to include the promise to transfer Product Z (in addition to the undelivered Product Y) to the customer on June 30, 20X1, and the price of the contract is increased by $300 (fixed consideration), which does not represent the standalone selling price of Product Z. The standalone selling price of Product Z is the same as the standalone selling prices of Products X and Y.

55-121 The entity accounts for the modification as if it were the termination of the existing contract and the creation of a new contract. This is because the remaining Products Y and Z are distinct from Product X, which had transferred to the customer before the modification, and the promised consideration for the additional Product Z does not represent its standalone selling price. Consequently, in accordance with paragraph 606-10-25-13(a), the consideration to be allocated to the remaining performance obligations comprises the consideration that had been allocated to the performance obligation for Product Y (which is measured at an allocated transaction price amount of $600) and the consideration promised in the modification (fixed consideration of $300). The transaction price for the modified contract is $900, and that amount is allocated equally to the performance obligation for Product Y and the performance obligation for Product Z (that is, $450 is allocated to each performance obligation).

55-122 After the modification but before the delivery of Products Y and Z, the entity revises its estimate of the amount of variable consideration to which it expects to be entitled to $240 (rather than the previous estimate of $200). The entity concludes that the change in estimate of the variable consideration can be included in the transaction price because it is probable that a significant reversal in cumulative revenue recognized will not occur when the uncertainty is resolved. Even though the modification was accounted for as if it were the termination of the existing contract and the creation of a new contract in accordance with paragraph 606-10-25-13(a), the increase in the transaction price of $40 is attributable to variable consideration promised before the modification. Therefore, in accordance with paragraph 606-10-32-45, the change in the transaction price is allocated to the performance obligations for Product X and Product Y on the same basis as at contract inception. Consequently, the entity recognizes revenue of $20 for Product X in the period in which the change in the transaction price occurs. Because Product Y had not transferred to the customer before the contract modification, the change in the transaction price that is attributable to Product Y is allocated to the remaining performance obligations at the time of the contract modification. This is consistent with the accounting that would have been required by paragraph 606-10-25-13(a) if that amount of variable consideration had been estimated and included in the transaction price at the time of the contract modification.

55-123 The entity also allocates the $20 increase in the transaction price for the modified contract equally to the performance obligations for Product Y and Product Z. This is because the products have the same standalone selling prices and the variable consideration does not meet the criteria in paragraph 606-10-32-40 that require allocation of the variable consideration to one but not both of the performance obligations. Consequently, the amount of the transaction price allocated to the performance obligations for Product Y and Product Z increases by $10 to $460 each.

55-124 On March 31, 20X1, Product Y is transferred to the customer, and the entity recognizes revenue of $460. On June 30, 20X1, Product Z is transferred to the customer, and the entity recognizes revenue of $460.

Question E348

When is a change in transaction price accounted for as a contract modification?

Interpretive response: It depends. A contract modification is a change in scope and/or price that either creates new or changes existing enforceable rights and obligations. An evaluation of facts and circumstances for the change in price is required and not all changes in price are contract modifications. This distinction is important because it affects when the change in price is recognized.

— **Resolution of variable transaction price.** The resolution of variability in the amount of expected consideration are accounted for as a change in transaction price and not a contract modification. Examples include the achievement of a performance bonus or resolution of an uncertainty that existed at contract inception that affects price.

— **Price concessions.** Pricing variability that is not explicitly stated in a contract is not presumed to be the result of a contract modification. It may instead be an implied term of the contract that could be inferred from the entity's historical business practices. If an entity has a history of granting price concessions or there is evidence of past performance issues or payment disputes, the resulting price changes would generally be attributed to the initial contract and not be accounted for as a contract modification. See Question D130.

— **External pressures on price.** Changes in market conditions, technological advances or competition in the marketplace could also cause an entity to change its pricing under an existing contract. When these types of changes are inconsistent with an entity's past practice, not anticipated at inception of the contract and are unrelated to performance issues, they would be accounted for as a contract modification.

For guidance on the accounting for contract modifications, see *Chapter G – Contract modifications.*

Material rights

Excerpt from ASC 606-10

>> Customer Options for Additional Goods or Services

55-44 Paragraph 606-10-32-29 requires an entity to allocate the **transaction price** to performance obligations on a relative standalone selling price basis. If the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity should estimate it. That estimate should reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

a. Any discount that the customer could receive without exercising the option
b. The likelihood that the option will be exercised.

55-45 If a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, then an entity may, as a practical alternative to estimating the standalone selling price of the option, allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration. Typically, those types of options are for contract renewals.

If a customer option to acquire additional goods or services represents a material right, an entity is required to estimate the stand-alone selling price of the option and allocate the transaction price on a relative stand-alone selling price basis to each performance obligation in the contract, which includes the material right. See *Chapter C – Step 2: Identify the performance obligations in the contract* for a discussion of material rights.

The stand-alone selling price of an option may be directly observable, and if that is the case the directly observable price should be used. If the stand-alone selling price is not directly observable, then an entity will need to estimate the stand-alone selling price of the material right.

Option pricing models generally take into account the intrinsic value and time value of the option. However, an entity is only required to estimate the intrinsic value of an option because the benefits of including the time value component would not justify the costs of making the estimate. [ASU 2014-09.BC390]

In estimating the stand-alone selling price of the material right an entity starts with the discount the customer would obtain when exercising the option and adjusts for:

- any discount that the customer would receive without exercising the option; and
- the likelihood that the option will be exercised.

The stand-alone selling price of the material right only includes the incremental discount provided through the current purchase. For example, if a contract with a customer included a material right that consisted of an option to purchase future goods or services at a 50% discount but the entity was also offering a 10% discount on the same products to all customers, the estimate of the stand-alone selling price would only consider the 40% discount that is incremental to what the customer could otherwise receive.

The guidance also specifies that the stand-alone selling price is adjusted for the likelihood that the option will be exercised. In effect, the stand-alone selling price of a material right includes estimated breakage. For example, if as part of a current purchase an entity provided the customer with an option to purchase an item at $50 that is normally sold for $100 (a 50% discount) the entity would start with the $50 discount and adjust for the probability of redemption. If the entity estimated that 80% of similar customer options are redeemed, the stand-alone selling price of the option would be $40 ($50 discount × 80% probability of exercise).

Question E349

Should an entity revise the stand-alone selling price of a material right if the entity's estimate of the likelihood of exercise changes?

Interpretive response: No, unless the alternative approach is used. The stand-alone selling price of performance obligations in a contract is not adjusted after contract inception even if the assumptions change. This is also true for the stand-alone selling price of material rights. To determine the stand-alone selling price of a material right, an entity estimates the likelihood that the customer will exercise the option at contract inception and that initial estimate is not revised. However, the estimates of the stand-alone selling price of a similar option in subsequent contracts may be affected by those changes in estimates. [606-10-32-43]

As a consequence, a customer's decision to exercise an option or allow the option to expire affects the timing of recognition for the material right, but it does not result in reallocation of the transaction price.

The exception is when an entity applies the alternative approach to estimating stand-alone selling price of an option. When an entity applies the alternative approach, any changes in the number of options exercised result in an adjustment to the transaction price and revenue recognized in accordance with Example 51 in Topic 606. [606-10-55-352]

We believe it is acceptable to adjust the number of expected goods or services on either a cumulative catch-up or prospective basis. However, an entity should establish a policy for the approach it uses and apply it consistently. See Example E370.1.

Alternative approach

Topic 606 provides an alternative approach to estimating the stand-alone selling price of a customer option when certain criteria are met. This alternative typically applies when a renewal option is considered a material right. Under this alternative, the entity would allocate the transaction price to the optional goods or services by reference to the goods or services it expects to provide and the corresponding consideration expected to be received. It could be easier to view a contract with renewal options as a contract for its expected term rather than estimating the stand-alone selling prices for each renewal. This is because estimating each renewal would require separately calculating the stand-alone selling price for each good or service and the likelihood that the customers will renew in each subsequent period. [ASU 2014-09.BC393]

This alternative can be applied when two criteria are met:

- the material right relates to goods or services that are similar to the original goods or services in the contract; and
- those goods or services are provided in accordance of the term of the original contract.

The first criterion specifies that the additional goods or services are similar to those provided under the initial contract. In other words, the entity is continuing to provide what it was already providing. For example, the alternative would typically apply to renewals of services provided in the original contract (e.g. renewals of PCS).

The second criterion specifies that the subsequent contracts must be provided in accordance with the terms of the original contract. In other words, the option price and goods or services the customer can acquire when exercising the option are fixed in the original contract. This criterion distinguishes between other types of options such as loyalty points or certain discount vouchers because, contrary to loyalty points or discount vouchers, the entity cannot change the pricing of the additional goods or services beyond the pricing in the original contract. [ASU 2014-09.BC395]

Comparison to legacy US GAAP

Topic 606 requires an entity to establish a stand-alone selling price for a customer option that provides the customer with a material right. This is not a requirement under legacy US GAAP. There were two approaches applied in practice to accounting for a significant incremental discount under legacy US GAAP.

— **General multiple element accounting guidance:** An entity was permitted to account for the option as a separate deliverable under general multiple element accounting guidance. This practice was similar to the accounting required under Topic 606.

— **Software revenue recognition guidance:** Although this guidance applied specifically to software arrangements (i.e. it was included within Subtopic 985-605), it was sometimes analogized to in the accounting for significant incremental discounts in non-software arrangements. This approach generally resulted in accounting that was different from that required by Topic 606 and typically resulted in a greater amount allocated to the future discount than the approach under Topic 606.

Under the legacy US GAAP software guidance, if an arrangement included a right to a significant incremental discount on a customer's future purchase of products (e.g. additional software licenses) or services, then a proportionate amount of that significant incremental discount was applied to each element based on its fair value (selling price) without regard to the significant incremental discount. For example, a 35% discount on future purchases would result in each element in the arrangement being recognized at a 35% discount to its fair value (selling price). This approach did not require an estimate of the selling price for that customer option. This is different from Topic 606's requirement to establish either an observable or estimated stand-alone selling price for a customer option that provides the customer with a material right.

Under legacy US GAAP, if the products to which the discount applied were not specified, or the fair value of the future purchases could not be determined but the maximum discount was quantifiable, the discount was allocated to the elements assuming that the customer would purchase the minimum amount necessary to receive the maximum discount. This legacy approach is different from Topic 606's guidance on estimating the stand-alone selling price of an option, which inherently includes an estimate of breakage (which typically will not be zero).

Lastly, under legacy US GAAP, if the discount was unlimited in a software arrangement (i.e. a customer could hypothetically buy an infinite amount of additional software licenses at a significant incremental discount), then revenue would be recognized under the subscription accounting model. The subscription model does not allocate revenue, but instead revenue is recognized ratably over the term or estimated term of the arrangement. This approach is different from Topic 606's allocation requirements. A similar option granted under Topic 606 would still be assigned an estimated stand-alone selling price and some portion of the arrangement consideration would be allocated to all performance obligations in the contract. As a consequence, if any performance obligations are satisfied upon contract inception (i.e. delivery of a software license), some portion of the arrangement consideration will be recognized immediately.

The Topic 606 guidance applicable to accounting for material rights will likely require entities to make additional estimates than under legacy US GAAP, which included more situations in which an entity would not have to estimate the selling price of a customer option. Entities will generally need to establish internal processes to make the new estimates for customer options and controls to ensure such estimates are reasonable and appropriate.

See *Chapter C – Step 2: Identify the performance obligations in the contract* for differences in identifying material rights compared to significant incremental discounts.

Question E350

In order to apply the alternative approach, does the outcome have to be the same as estimating the stand-alone selling price for each option?

Interpretive response: No. The alternative approach may result in a different accounting outcome. Depending on the individual facts and circumstances the difference could result in more or less of the transaction price being deferred and recognized as the options are exercised.

Regardless of the approach an entity selects, it should apply that approach consistently to similar circumstances.

Question E355

Is the alternative approach limited to renewals of services?

Interpretive response: No. The FASB discussed the concept of the practical alternative only in terms of service renewals. However, we believe this alternative can be applied to a material right for the purchase of additional goods – assuming the material right relates to goods that are similar to the original goods in the contract and are provided in accordance with the terms of the original contract. [606-10-55-45]

Question E360

When an option to renew a good or service provides a material right, can an entity apply the alternative approach to allocating the transaction price when there are other goods or services in the initial contract?

Interpretive response: Yes. We believe that the entity does not need to have the option to renew all of the goods or services in the original contract in order to qualify for the alternative method.

For example, a software entity often sells a perpetual license and PCS with contractually stated renewal options for PCS. When the option to renew PCS is determined to be a material right – e.g. the renewal price for the PCS is lower than the price for the same PCS the entity offers to similarly situated customers *that have not entered into a contract with the entity previously* -- the software entity needs to account for the material right as a separate performance obligation.

A software entity providing a license and PCS with contractually stated renewal options will generally qualify for the alternative method. That is because the option provides the customer the ability to purchase a service similar to a service provided in the original contract and the contract explicitly states the terms of the renewal.

Question E370

If an entity applies the alternative approach of allocating the transaction price to a material right, how should the entity determine the amount of goods or services expected to be provided?

Interpretive response: The alternative approach to estimating the stand-alone selling price of an option allows an entity to allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration. However, Topic 606 does not provide detailed guidance on how to determine what are the expected goods or services.

For example, an entity may enter into a contract to sell a software license and one year of PCS with two contractually stated annual renewal options for the PCS. When the option to renew the PCS provides the customer with a material right, the entity typically will be able to either directly estimate the stand-alone selling price of the options or apply the alternative method.

Example 51 in Topic 606 (paragraphs 606-10-55-343 through 55-352) illustrates the application of the alternative approach to a service arrangement whereby the entity estimates the number of contracts expected to be renewed for a portfolio of contracts. In that example, the entity enters into 100 similar annual contracts with two renewal periods around the same time. The entity estimates the number of expected renewals for the portfolio to estimate the transaction price and to allocate consideration to the initial and renewal contracts. Paragraph 606-10-55-352 states that if the actual number of contract renewals were different than what the entity expected, the entity would update the transaction price and revenue recognized accordingly. We believe it is acceptable to adjust the number of expected goods or services during the period(s) for which a material right exists, on either a cumulative catch-up or prospective basis as long as the entity establishes a policy for the approach it uses and applies it consistently.

Based on Example 51, a similar approach would be acceptable whereby the entity estimates the number of goods or services expected to be provided based on historical data for a portfolio of similar transactions. However, we believe that an entity could estimate the expected goods or services on a contract by contract basis.

Contract-by-contract basis

When an entity estimates the expected goods or services on a contract by contract basis, the entity should consider each option that provides the customer with a material right to be a 'good or service that is expected to be provided' unless the entity expects the customer's right to expire unexercised (e.g. it would be likely that the right will expire unexercised). To determine whether an entity expects the customer's right to expire unexercised the entity should consider the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration (see *Chapter D – Step 3: Determine the transaction price*).

The approach outlined in the preceding paragraph is consistent with the guidance on 'breakage' in Topic 606 (paragraphs 606-10-55-46 through 55-49) and ensures that the entity's obligation to provide future goods or services is not understated by allocating an appropriate amount of consideration to the material right. We believe the analogy to breakage is appropriate because the alternative method factors in breakage based on the number of goods or services included in the contract rather than in estimating the stand-alone selling price of the option.

Further, we believe that under this alternative, the estimate of the hypothetical transaction price does not need to be further adjusted for the likelihood of exercise. This is because breakage is already considered in the determination of the expected goods or services to be provided. Moreover, the alternative approach is intended to relieve entities from the complexity of estimating the stand-alone selling price of an option inclusive of the likelihood that the customer will exercise the option when it is conditional on a series of renewals throughout the contract term. For example, if an entity includes a renewal option with a contract price of $100 that has a 60% probability of being exercised, we believe that the entity includes $100 in the hypothetical transaction price rather than $60; this is because the $100 is the 'corresponding expected consideration' for the additional good or service. The entity would then allocate the hypothetical transaction price (which includes the $100) to all of the expected goods or services including the renewal option on a relative stand-alone selling price basis.

If the actual number of contract renewals is different from what the entity expected, the entity updates the transaction price and revenue recognized accordingly. We believe it is acceptable to adjust the number of expected goods or services during the period(s) for which a material right exists, on either a cumulative catch-up or prospective basis as long as the entity establishes a policy for the approach it uses and applies it consistently. If a renewal option is not exercised, any remaining revenue is recognized when the material right expires unexercised.

Under a contract by contract approach, we believe it is also acceptable for an entity to include all of the options that represent a material right in the hypothetical transaction price and then estimate the transaction price based on the likelihood of exercise similar to Example 51 in Topic 606. For example, if an entity includes a renewal option with a contract price of $100 that has a 60% probability of being exercised, the entity could include $60 in the hypothetical transaction price.

Example E370.1

Estimating stand-alone selling price – material rights

Software Vendor M (M) enters into 100 contracts to provide a perpetual license for $10,000 and one year of PCS for $2,000, both of which are equal to their stand-alone selling price. Each contract provides Customer the option to renew the annual PCS for $1,000 for two additional years. M concludes that the license and the PCS are separate performance obligations.

M also concludes that each renewal option provides a material right to Customer that it would not receive without entering into the contract because the discount is significant to what the entity charges other similarly situated customers.

Topic 606 allows two approaches to allocate the transaction price to renewal options. The following illustrates the allocation of the transaction price to the material right under both approaches.

Approach 1: Estimate the stand-alone selling price of each option

Under Approach 1, M estimates the stand-alone selling price of each performance obligation and the two material rights in the contract. To estimate the stand-alone selling price of each material right, M calculates the discount the Customer would receive from exercising the option adjusted for the probability of renewal.

M expects 90 customers to renew at the end of Year 1 (90% of contracts sold) and 81 customers to renew at the end of Year 2 (90% of the 90 customers that renewed at the end of Year 1).

M estimates the stand-alone selling price for each material right as follows.

Option	Discount	Probability of renewal	Stand-alone selling price
Renewal Option 1	$1,000	90%	$900
Renewal Option 2	$1,000	81%	$810

M then allocates the transaction price on a relative stand-alone selling price basis as follows.

Performance obligation	Stand-alone selling price	Allocation %	Allocated consideration
Perpetual license	$10,000	73.0%	$ 8,760
PCS Year 1	2,000	14.5%	1,740
Material right – renewal Option 1	900	6.5%	780
Material right – renewal Option 2	810	6.0%	720
Total	**$13,710**	**100.0%**	**$12,000**

In Year 1, M would recognize $8,760 when it transfers control of the license and $1,740 as the entity satisfies the PCS performance obligation. The difference between the amounts recognized as revenue and the consideration received of $1,500 ($12,000 – $8,760 – $1,740) would be recognized as a contract liability.

When the customer exercises Option 1, the entity would recognize $1,780 ($1,000 additional consideration plus $780 allocated to Option 1) as the entity satisfies its performance obligation under the renewal contract. When the customer exercises Option 2, the entity would recognize $1,720 ($1,000 additional consideration plus $720 allocated to Option 2).

If the customer does not exercise its option, M would recognize as revenue the amounts allocated to all remaining options.

Approach 2: Apply the alternative approach

If M applies the alternative method, it would allocate the transaction price by reference to the goods or services expected to be provided and corresponding expected consideration. To apply the alternative method, Entity M could either estimate the transaction price based on a portfolio or on a contract by contract basis.

Portfolio of data

M would estimate the total number of expected goods or services for the 100 contracts based on expectations for similar customers. M estimates the number of renewals and corresponding expected transaction price. M also concludes that the stand-alone selling price for each PCS period is the same. Based on the entity's estimates, the transaction price is allocated to each performance obligation as follows.

Performance obligation	Contract price	Expected renewals	Expected consideration	Stand-alone selling price expected goods	Allocation %	Relative allocation
Perpetual license	$10,000	n/a	$10,000	$10,000	65.0%	$ 8,911
PCS Year 1	2,000	n/a	2,000	2,000	13.0%	1,782
Renewal Option 1	1,000	90%	900	1,800	11.5%	1,577
Renewal Option 2	1,000	81%	810	1,620	10.5%	1,440
Total	**$14,000**		**$13,710**	**$15,420**	**100.0%**	**$13,710**

In Year 1, M would recognize $891,100 (100 contracts × $8,911) when it transfers control of the license and $178,200 (100 contracts × $1,782) as the entity satisfies the PCS performance obligation. The difference between the amounts recognized and amounts received of $130,700 ($1,200,000 – $891,100 – $178,200) would be recognized as a contract liability. The amounts allocated to subsequent years would be recognized as the performance obligations are satisfied.

If the actual number of renewals is different from what was expected, M's policy is to update the transaction price and recognize revenue with a cumulative catch-up adjustment. For example, if 95 customers exercise the first renewal option, M would update the transaction price and reallocate the consideration to each performance obligation. The expected consideration would be adjusted as follows.

Performance obligation	Contract price	Expected renewals	Expected consideration	Stand-alone selling price expected goods	Allocation %	Relative allocation
Perpetual license	$10,000	n/a	$10,000	$10,000	64.0%	$ 8,835
PCS Year 1	2,000	n/a	2,000	2,000	12.8%	1,767
Renewal Option 1	1,000	95%	950	1,900	12.2%	1,685
Renewal Option 2	1,000	85.5%	855	1,710	11.0%	1,518
Total	**$14,000**		**$13,805**	**$15,610**	**100.0%**	**$13,805**

At the beginning of Year 2, M would record an adjustment to reverse revenue allocated to the license and PCS Year 1 of $9,100 [($8,835 + $1,767) – ($8,911+$1,782) × 100 contracts]. M would recognize $168,500 ($1,685 × 100 contracts) as it satisfies the PCS during the first renewal option period. At the end of Year 2, M would have a contract liability of $66,300 [$1,295,000 of total consideration received – $1,228,700 of revenue recognized]. In Year 3, if there is no change in expected renewals the entity would recognize $151,800 of revenue ($66,300 contract liability + $85,500 remaining consideration received).

Contract by contract basis

If M applies the alternative method on a contract by contract approach, M must estimate the goods or services it expects to provide and corresponding expected consideration. M has a material right for both Option 1 and Option 2 and does not expect the rights to go unexercised. M considered the factors in paragraph 606-10-32-12 when determining whether either of the rights would go unexercised and noted that:

- the exercise is out of the entity's control;
- the uncertainty will not be resolved for a long period of time;
- while M has experience with similar customers and has data that suggests there will be some breakage, the historical evidence indicates that on a customer by customer basis that it would not expect either of the options to expire unexercised.

Performance obligation	Contract price	Expected consideration	Stand-alone selling price expected goods	Allocation %	Relative allocation
Perpetual license	$10,000	$10,000	$10,000	62.5%	$ 8,750
PCS Year 1	2,000	2,000	2,000	12.5%	1,750
Renewal Option 1	1,000	1,000	2,000	12.5%	1,750
Renewal Option 2	1,000	1,000	2,000	12.5%	1,750
Total	**$14,000**	**$14,000**	**$16,000**	**100.0%**	**$14,000**

In Year 1, M would recognize $8,750 when it transfers control of the license and $1,750 as it satisfies the PCS performance obligation. The difference between the amounts recognized as revenue and consideration received of $1,500 ($12,000 – $8,750 – $1,750) would be recognized as a contract liability. The amounts allocated to subsequent years would be recognized as the performance obligations are satisfied.

If the customer does not exercise its option, M would recognize as revenue the amounts allocated to all remaining options.

Question E380

When an upfront fee gives rise to a material right, but the renewal price is not specified in the initial contract, can the alternative approach be applied?

Interpretive response: Generally, yes. One of the criteria to apply the alternative approach is that the optional goods or services are provided in accordance with the terms of the original contract. Sometimes an entity may provide the customer with an option to renew at a price negotiated at the time of the renewal, or at the then market rate, or the contract may be silent on renewals but there is a reasonable expectation by the customer that it has the right to renew the service.

When a renewal option or price is not specified in the original contract, we believe the alternative approach can be applied if a nonrefundable upfront fee conveys a material right and the entity's past practice creates a reasonable expectation that the customer:

— will avoid paying an upfront fee on renewal; and
— will pay a renewal price consistent with renewal pricing given to a similar class of customer.

However, the optional good or service expected to be provided needs to be similar to the good or service in the original contract.

We believe this conclusion is consistent with the FASB's intent. This is because the criteria to apply the alternative approach are intended to distinguish between renewal options and other types of material rights such as loyalty points and discount vouchers. The criterion that requires additional goods and services to be provided under the original contract's terms makes this distinction for loyalty points and discount vouchers. Because an entity can change the pricing of the additional goods or services under those programs beyond the parameters specified in the original contract, the alternative approach cannot be applied in those scenarios. For example, an airline can change the number of points that must be redeemed to obtain a flight, thereby changing the discount (e.g. the value of the points) that was given in the original contract. [ASU 2014-09.BC394–BC395]

Although an entity could change the price of the renewals in the renewal option scenario, we believe the contract terms that convey the material right (i.e. the upfront fee) should be the terms that are evaluated under this criterion. If the customer has a reasonable expectation that it will avoid an additional upfront fee when the contract is renewed, the terms that create the material right are implied in the original contract. In contrast, the discount provided in a voucher or loyalty point scenario is determined at the time the option is exercised.

Example E380.1
Nonrefundable upfront fees – alternative approach

Customer enters into a one-year service contract with SAAS Corp. The terms of the contract require Customer to pay a fixed monthly fee of $100, plus a nonrefundable upfront fee of $4,000. The contract does not specify a renewal option or pricing, but SAAS Corp has a history of renewing these types of contracts at prices consistent with similar customers without requiring payment of the upfront fee again on renewal.

The nonrefundable upfront fee relates to set-up activities and not a promised good or service. SAAS Corp concludes that the upfront fee gives rise to a material right because Customer would not have to pay the upfront fee if the service is renewed at the end of the one-year term.

SAAS Corp also concludes that the alternative approach can be applied to estimate the stand-alone selling price of the renewal option. This is because the renewal services will be substantially the same as the services provided under the original contract and the renewal price will be determined consistent with the renewal pricing given to similar customers.

Question E390

How should an entity determine the expected goods or services under the alternative approach when an upfront fee gives rise to a material right?

Interpretive response: When a contract includes an upfront fee that conveys a material right, an entity has two potential approaches to allocate consideration to the material right:

- determine the stand-alone selling price of the right and allocate based on a relative stand-alone selling price basis; or
- the alternative approach, which allocates the transaction price to the optional goods or services it expects to provide by reference to those expected goods or services and the corresponding expected consideration.

If an entity qualifies for and elects to apply the alternative approach, it estimates the goods or services it expects to provide and the corresponding consideration it expects to receive. However, Topic 606 does not provide detailed guidance on how to make this determination. As discussed in Question E370, we believe that entities can apply a method based on a portfolio of data or a method based on an individual contract.

We believe the following are acceptable methods for applying the alternative approach when an upfront fee conveys a material right. Under any of these methods, the expected goods or services are limited to the period a material right exists. See Question C410 for guidance on determining the period the material right exists.

Method 1: Portfolio of data incorporating estimates of breakage with adjustments for changes in estimate

Method 1 is similar to Example 51 in Topic 606 whereby the entity estimates the expected renewals and corresponding expected consideration for a portfolio of similar contracts.

Under this method, an entity estimates breakage using the portfolio of data. For example, if the portfolio comprises 100 contracts and there is a material right for a single renewal period, the entity estimates how many of the 100 contracts will be renewed. The entity then allocates the expected consideration between the original contract and expected renewals.

If the actual renewals are different from the original estimate, the entity adjusts the number of expected goods or services, transaction price and revenue recognized. See Example E370.1. [606-10-55-352]

Based on discussions with the FASB staff, we believe it is acceptable to adjust the number of expected goods or services on a cumulative catch-up or prospective basis.

Method 2: Amortization of upfront fee over weighted-average expected renewal period

Under Method 2, an entity amortizes the upfront fee over the period of expected renewals in a pattern consistent with the measure of progress for that performance obligation. This method allocates the consideration to the expected renewal periods rather than to the expected goods or services.

Method 2 takes into account a portfolio of data similar to Method 1; however, this method sets a weighted-average amortization period for the upfront fee rather than calculating a specific number of renewals each period. Both Methods 1 and 2 incorporate an estimate of breakage.

This method differs from Method 1 because an entity does not track actual versus estimated renewals for a particular portfolio (e.g. contracts entered into in a single month/quarter) and make an adjustment to true up to actual renewals. The monitoring of the renewal experience is done at a higher level. An entity monitors its weighted-average expected renewal period for similar customers and updates the revenue recognized for the change in estimate using either a cumulative catch-up or prospective adjustment.

However, we believe an approach where an entity establishes an amortization period with no monitoring for subsequent changes in actual results would not be appropriate.

Method 3: Contract-by-contract approach

Under Method 3, an entity includes the expected goods or services and corresponding consideration for a specific contract rather than calculating breakage using a portfolio of contracts. We believe this method is consistent with the FASB's intent for the alternative approach to allow entities to avoid the complex calculations needed to estimate the likelihood of a series of renewal periods. [ASU 2014-09.BC392–BC393]

Under this method, the entity includes each option that provides the customer with a material right in the contract to be a 'good or service that is expected to be provided' unless it expects the right to expire unexercised – e.g. it is likely that the right will expire unexercised.

If the actual renewals are different from the original estimate, the entity adjusts the number of expected goods or services using either a cumulative catch-up or prospective adjustment. In the event a renewal option is not exercised, any remaining contract liability is recognized as revenue. This method requires an entity to monitor each of its contracts separately to make an adjustment based on actual renewals.

Example E390.1 further illustrates these methods when applying the alternative approach.

Example E390.1

Estimating stand-alone selling price in a contract with an upfront fee that gives rise to a material right – comprehensive example

SAAS Corp enters into a one-year SAAS service contract with Customer for a fixed fee of $4,000, which is billed upfront. In addition, SAAS Corp charges a one-time nonrefundable upfront fee of $1,000. Customer can renew the service for 10 annual time increments at a rate of $4,000 per year.

SAAS Corp concludes that the nonrefundable upfront fee relates to set-up activities that do not result in the transfer of goods or services to Customer.

Further, SAAS Corp concludes that the upfront fee gives rise to a material right because it is significant and Customer would not have to pay another upfront fee upon renewal.

SAAS Corp considers various data points to determine the period over which the entity has a material right (see Question C410). Those data points include the average customer life, the significance of the upfront fee and other qualitative factors to determine the period Customer benefits from not having to pay the upfront fee (i.e. the number of periods not having to pay the upfront fee influences Customer's renewal decision). Based on this analysis, SAAS Corp concludes that Customer only has a material right for two renewal periods.

SAAS Corp also concludes that the services are satisfied over time and a time-elapsed measure of progress is appropriate.

SAAS Corp considers the various methods of allocating the transaction price to the performance obligations – one year of service and two material rights.

Approach 1: Estimate the stand-alone selling price of each option

To estimate the stand-alone selling price of each material right, SAAS Corp calculates the discount Customer would receive from exercising the option adjusted for the probability of renewal. SAAS Corp concludes the discount is $1,000, which is the nonrefundable upfront fee that would not need to be paid upon exercising renewal option 1 and renewal option 2.

SAAS Corp expects 85% of customers to renew at the end of Year 1 and 72% of the original customers to renew at the end of Year 2 (i.e. 85% of the customers that renewed in Year 1 will renew in Year 2 (85% × 85% = 72%)).

SAAS Corp estimates the stand-alone selling price for each material right as follows.

Option	Discount	Probability of renewal	Stand-alone selling price
Renewal option 1	$1,000	85%	$850
Renewal option 2	$1,000	72%	$720

SAAS Corp then allocates the transaction price on a relative stand-alone selling price basis as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Service contract Year 1	$5,000	76.1%	$3,805
Material right – renewal option 1	850	12.9%	645
Material right – renewal option 2	720	11.0%	550
Total	**$6,570**	**100%**	**$5,000**

SAAS Corp records the following journal entries, assuming that Customer exercises the renewal options.

	Debit	*Credit*
Cash/trade receivables	5,000	
Contract liability		5,000
To recognize a contract liability when upfront billing occurs at beginning of Year 1.		
Contract liability	3,805	
Revenue		3,805
To recognize revenue ratably as service contract performance obligation is satisfied over Year 1.		
Cash/trade receivables	4,000	
Contract liability		4,000
To recognize a contract liability when upfront billing occurs at beginning of Year 2.		
Contract liability	4,645	
Revenue		4,645
To recognize revenue ratably after renewal option 1 is exercised and service performance obligation satisfied over Year 2.		
Cash/trade receivables	4,000	
Contract liability		4,000
To recognize a contract liability when upfront billing occurs at beginning of Year 3.		
Contract liability	4,550	
Revenue		4,550
To recognize revenue ratably after renewal option 2 is exercised and service performance obligation satisfied over Year 3.		

If Customer does not exercise an option, SAAS Corp recognizes as revenue the amounts allocated to all remaining options.

Note: There may be other methods to estimate the stand-alone selling price of a material right as long as they are consistent with the allocation objective and material rights guidance. We believe the above illustrates an acceptable approach.

Approach 2: Apply the alternative approach

Method 1: Portfolio of data incorporating estimates of breakage

Based on its estimates of expected renewals for a portfolio of contracts, SAAS Corp allocates the transaction price to each performance obligation as follows.

Performance obligation	Contract price	Expected renewals	Expected consideration	Stand-alone selling price	Selling price ratio	Price allocation
Service contract Year 1	$ 5,000[1]	n/a	$ 5,000	$ 5,000	38.9%	$ 4,388
Renewal option 1	4,000	85%	3,400[2]	4,250[4]	33.1%	3,734
Renewal option 2	4,000	72%	2,880[3]	3,600[5]	28.0%	3,158
Total	**$13,000**		**$11,280**	**$12,850**	**100%**	**$11,280**

Notes:

1. Calculated as $4,000 + 1,000
2. Calculated as $4,000 × 85%
3. Calculated as $4,000 × 72%
4. Calculated as $5,000 × 85%
5. Calculated as $5,000 × 72%

In Year 1, SAAS Corp recognizes $4,388 as it satisfies the related service performance obligation. The difference between the amount recognized as revenue and consideration received of $612 ($5,000 – $4,388) is recognized as a contract liability.

If at the beginning of the first renewal period the actual number of renewals are different, SAAS Corp updates the transaction price and revenue recognized accordingly through either a cumulative catch-up or prospective adjustment approach, pursuant to paragraph 606-10-55-32.

For example, if 95% of customers exercise their renewal option upon completion of the one-year service contract, SAAS Corp updates the transaction price and reallocates the consideration to each performance obligation as follows.

Cumulative catch-up adjustment approach

Performance obligation	Contract price	Expected renewals	Expected consideration	Stand-alone selling price	Selling price ratio	Price allocation
Service contract Year 1	$ 5,000[1]	n/a	$ 5,000	$ 5,000	35.7%	$ 4,356
Renewal option 1	4,000	95%	3,800[2]	4,750[4]	33.9%	4,136

Performance obligation	Contract price	Expected renewals	Expected consideration	Stand-alone selling price	Selling price ratio	Price allocation
Renewal option 2	4,000	85%[6]	3,400[3]	4,250[5]	30.4%	3,708
Total	**$13,000**		**$12,200**	**$14,000**	**100%**	**$12,200**

Notes:

1. Calculated as $4,000 + 1,000
2. Calculated as $4,000 × 95%
3. Calculated as $4,000 × 85%
4. Calculated as $5,000 × 95%
5. Calculated as $5,000 × 85%
6. Assume SAAS Corp's updated estimate of expected renewals for Option 2 is now 85%

Under the cumulative catch-up adjustment approach, SAAS Corp records the following journal entry at the beginning of Year 2 to take into account the change in expectation.

	Debit	*Credit*
Revenue	32[1]	
Contract liability		32
To reverse revenue from Year 1 at the start of Year 2, based on adjustment to allocation of consideration.		

Note:

1. Calculated as $4,388 – $4,356.

Prospective adjustment approach

Under a prospective adjustment approach, SAAS Corp does not adjust the contract liability when the estimate changes but updates the allocation on a prospective basis as follows.

Performance obligation	Contract price	Expected renewals	Remaining expected consideration	Stand-alone selling price	Selling price ratio	Price allocation
Service contract Year 1	$ 5,000[1]	n/a	n/a	n/a	n/a	n/a
Renewal option 1	4,000	95%	$3,800[2]	$4,750[4]	52.8%	$4,125
Renewal option 2	4,000	85%	3,400[3]	4,250[5]	47.2%	3,687
Contract liability	n/a	n/a	612[6]	n/a	n/a	
Total	**$13,000**		**$7,812**	**$9,000**	**100%**	**$7,812**

Notes:
1. Calculated as $4,000 + 1,000
2. Calculated as $4,000 × 95%
3. Calculated as $4,000 × 85%
4. Calculated as $5,000 × 95%
5. Calculated as $5,000 × 85%
6. Contract liability after Year 1

SAAS Corp records the following journal entry as it satisfies the related service performance obligation in Year 2, which takes into account the change in estimate.

	Debit	*Credit*
Cash/trade receivables	3,800	
Contract liability	325	
Revenue		4,125
To recognize revenue as the related service performance obligation is satisfied in Year 2, while adjusting for the change in estimate for renewals.		

At the end of year 2 the contract liability is $287 ($612 – $325).

Method 2: Amortization over a weighted-average expected renewal period

Assume SAAS Corp determines that the weighted-average expected renewal period for similar customers is 30 months. For an individual customer that exercises all its options, SAAS Corp calculates revenue to be recognized as follows.

Performance obligation	Actual service revenue per contract	Upfront fee	Revenue recognized
Service Year 1	$ 4,000	$ 400[1]	$ 4,400
Renewal option 1	4,000	400[1]	4,400
Renewal option 2	4,000	200[2]	4,200
Total	**$12,000**	**$1,000**	**$13,000**

Notes:
1. Calculated as ($1,000 / 30 months) × 12 months
2. Calculated as (1,000 / 30 months) × 6

In Year 1, SAAS Corp recognizes $4,400 as it satisfies the related service performance obligation. The difference between the amount recognized as revenue and consideration received of $600 ($5,000 – $4,400) is recognized as a contract liability.

SAAS Corp monitors its weighted-average expected renewal period for similar customers and updates the revenue recognized with either a cumulative catch-up or prospective adjustment, if necessary.

Method 3: Contract-by-contract approach

SAAS Corp does not expect the material right to expire unexercised and therefore includes all of the material right periods as expected services. This results in effectively amortizing the upfront fee ratably over the hypothetical contract because the entity uses a time-elapsed measure of progress.

Performance obligation	Contract price	Expected consideration	Selling price ratio	Price allocation
Service contract Year 1	$ 5,000	$ 5,000	33.3%	$ 4,333
Renewal option 1	4,000	4,000	33.3%	4,333
Renewal option 2	4,000	4,000	33.3%	4,333
Total	**$13,000**	**$13,000**	**100%**	**$13,000**

In Year 1, SAAS Corp recognizes $4,333 as it satisfies the related service performance obligation. The difference between the amount recognized as revenue and consideration received of $667 ($5,000 – $4,333) is recognized as a contract liability.

If Customer does not exercise an option, SAAS Corp recognizes as revenue the amount allocated to the remaining renewal options.

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

Questions and Examples

Recognition of distinct software licenses

Q&A F100 Can a software entity begin recognizing revenue on a distinct software license renewal before the commencement of the renewal term?

Example F100.1: Renewal license and bundled PCS

Q&A F110 When does control of a distinct software license transfer to the customer in a hosting arrangement?

Q&A F120 If a software entity contracts with a customer for a license to a specified software product that is not yet available for release, has the entity transferred control of the license if it makes available a substantially equivalent software product (including a limited-release or beta version of the soft-ware) with the promise to deliver the specified software product once it is ready for distribution?

Example F120.1: Early release version of software product

Q&A F125 Does granting price concessions to resellers/distributors affect whether control has transferred?

Revenue recognition for software-as-a-service and services that are software-related

Q&A F130 Is a performance obligation to provide software-as-a-service satisfied over time?

Example F130.1: Software-as-a-service

Q&A F140 Are hosting services provided in a software licensing arrangement satisfied over time?

Q&A F150 Is a performance obligation to provide technical support services satisfied over time?

Example F150.1: Technical support services

Q&A F160 Is a performance obligation to provide unspecified updates, upgrades and enhancements satisfied over time?

Q&A F170 Is a combined performance obligation to provide a non-distinct software license and non-distinct unspecified updates, upgrades and enhancements (and/or unspecified software licenses to additional products) satisfied over time?

Q&A F180 Is a performance obligation to provide implementation services in a software licensing arrangement satisfied over time?

Q&A F190 Is a performance obligation to provide implementation services in a SaaS arrangement satisfied over time?

Example F190.1: Distinct implementation services in a SaaS arrangement

Q&A F200 Is a combined performance obligation to provide a software license and customization services satisfied over time?

Example F200.1: Combined software license and customization services performance obligation

Q&A F201 Does an entity have an enforceable right to payment if the contract does not explicitly state the entity's right to payment upon contract termination?

Q&A F202 Does the entity's ability and intent to sue if the customer terminates the contract indicate that it has an enforceable right to payment?

Q&A F203 Does an entity need to obtain a legal opinion to assess whether it has an enforceable right to payment?

Q&A F204 Can an enforceable right to payment exist for a contract priced at a loss when an entity is not entitled to cost plus a margin for performance completed to date?

Q&A F210 How do customer acceptance provisions affect whether a performance obligation is satisfied over time?

Q&A F212 How does a software entity account for additional fees identified through an audit of customer usage?

Example F212.1: User license audits

Q&A F216 How does a software entity recognize fees associated with a settlement with a non-customer who used the entity's software without obtaining a license?

Measuring progress toward complete satisfaction of a performance obligation satisfied over time

Q&A F220 When is it not appropriate to recognize revenue for a technical support or unspecified updates/ upgrades/enhancements 'stand-ready obligation' on a straight-line basis?

Example F220.1: Time-based measure of progress for technical support services

Example F220.2: Time-based measure of progress appropriate for unspecified updates, upgrades and enhancements

Q&A F230 What is an appropriate measure of progress for a combined performance obligation that includes a software license and rights to unspecified updates, upgrades and enhancements (and/or rights to use unspecified additional software products)?

Q&A F235 When should an entity begin to recognize revenue for a 'stand-ready' service promised to a customer's customer?

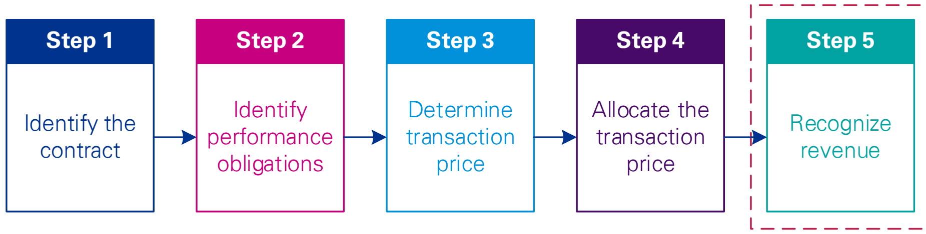
Q&A F240 What is an appropriate measure of progress for a combined performance obligation comprised of software-as-a-service and professional services?

Example F240.1: Software-as-a-service and non-distinct services

Q&A F250 What is an appropriate measure of progress for a 'hybrid SaaS' arrangement in which the on-premise software license and the software-as-a-service (SaaS) element are a single performance obligation?

Sales- or usage-based royalties promised in exchange for a license of IP

Q&A F340	Should a software entity account for a minimum guaranteed royalty promised in exchange for a software license as fixed consideration or in accordance with the 'royalties recognition constraint'?
	Example F340.1: Software license with a guaranteed minimum
Q&A F350	Is it acceptable under Topic 606 to recognize revenue resulting from a sales- or usage-based royalty in a period subsequent to the period in which the customer's subsequent sales or usage occur if the entity does not receive reporting on those sales or usage timely (i.e. on a 'lag' basis)?
	Example F350.1: Royalties report received after financial statements are issued
Q&A F360	Are payments with fixed monetary amounts, such as milestone payments, determined by reference to sales- or usage-based thresholds, a sales- or usage-based royalty?
	Example F360.1: Milestone payments linked to sales- or usage-based amounts
	Example F360.2: Milestone payments linked to sales- or usage-based amounts and other items
Q&A F370	If a sales- or usage-based royalty relates to more than one license and other goods and services, does the royalties recognition constraint apply if no single license is predominant?
Q&A F380	Is a promise to provide future updates, upgrades and enhancements a license of IP for purposes of determining the applicability of the royalties recognition constraint?
Q&A F385	Can the royalty exception apply when a software license is not distinct from other goods or services?
Q&A F390	Does a declining royalty rate that applies prospectively create a material right for the customer with respect to future sales or usage of a software license subject to the royalties recognition constraint?
	Example F390.1: Declining royalties – Prospective basis
Q&A F400	Does a declining royalty rate that applies retrospectively preclude recognition of royalties when the customer's subsequent sales or usage occur?
	Example F400.1: Declining royalties – Retrospective basis
Q&A F410	In an increasing royalty rate scenario, should the entity recognize revenue at its expected 'blended' rate?
	Example F410.1: Increasing royalty rate
Q&A F420	How should a software entity attribute revenue from a sales- or usage-based royalty subject to the royalties constraint allocable to a performance obligation satisfied over time?



This chapter is organized into four sections:

- Revenue recognition of distinct software licenses
- Revenue recognition for software-as-a-service and services that are software-related
- Measuring progress toward complete satisfaction of a performance obligation satisfied over time
- Sales-based or usage-based royalties promised in exchange for a license of IP

Recognition of distinct software licenses

Excerpt from ASC 606-10

>> Performance Obligations Satisfied at a Point in Time

25-30 If a **performance obligation** is not satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a **customer** obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the guidance on control in paragraphs 606-10-25-23 through 25-26. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

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. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.

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 shall 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. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.

>> Licensing

55-54 A license establishes a customer's rights to the intellectual property of an entity. Licenses of intellectual property may include, but are not limited to, licenses of any of the following:

a. Software (other than software subject to a hosting arrangement that does not meet the criteria in paragraph 985-20-15-5) and technology
b. Motion pictures, music, and other forms of media and entertainment
c. Franchises
d. Patents, trademarks, and copyrights.

55-55 In addition to a promise to grant a license (or licenses) to a **customer**, an entity may also promise to transfer other goods or services to the customer. Those promises may be explicitly stated in the **contract** or implied by an entity's customary business practices, published policies, or specific statements (see paragraph 606-10-25-16). As with other types of contracts, when a contract with a customer includes a promise to grant a license (or licenses) in addition to other promised goods or services, an entity applies paragraphs 606-10-25-14 through 25-22 to identify each of the **performance obligations** in the contract.

55-56 If the promise to grant a license is not distinct from other promised goods or services in the contract in accordance with paragraphs 606-10-25-18 through 25-22, an entity should account for the promise to grant a license and those other promised goods or services together as a single performance obligation. Examples of licenses that are not distinct from other goods or services promised in the contract include the following:

a. A license that forms a component of a tangible good and that is integral to the functionality of the good
b. A license that the customer can benefit from only in conjunction with a related service (such as an online service provided by the entity that enables, by granting a license, the customer to access content).

55-57 When a single performance obligation includes a license (or licenses) of intellectual property and one or more other goods or services, the entity considers the nature of the combined good or service for which the customer has contracted (including whether the license that is part of the single performance obligation provides the customer with a right to use or a right to access intellectual property in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A) in determining whether that combined good or service is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and, if over time, in selecting an appropriate method for measuring progress in accordance with paragraphs 606-10-25-31 through 25-37.

55-58 In evaluating whether a license transfers to a customer at a point in time or over time, an entity should consider whether the nature of the entity's promise in granting the license to a customer is to provide the customer with either:

a. A right to access the entity's intellectual property throughout the license period (or its remaining economic life, if shorter)
b. A right to use the entity's intellectual property as it exists at the point in time at which the license is granted.

55-58A An entity should account for a promise to provide a customer with a right to access the entity's intellectual property as a performance obligation satisfied over time because the customer will simultaneously receive and consume the benefit from the entity's performance of providing access to its intellectual property as the performance occurs (see paragraph 606-10-25-27(a)). An entity should apply paragraphs 606-10-25-31 through 25-37 to select an appropriate method to measure its progress toward complete satisfaction of that performance obligation to provide access to its intellectual property.

55-58B An entity's promise to provide a customer with the right to use its intellectual property is satisfied at a point in time. The entity should apply paragraph 606-10-25-30 to determine the point in time at which the license transfers to the customer.

55-58C Notwithstanding paragraphs 606-10-55-58A through 55-58B, revenue cannot be recognized from a license of intellectual property before both:

a. An entity provides (or otherwise makes available) a copy of the intellectual property to the customer.
b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property. That is, an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.

>>> Determining the Nature of the Entity's Promise

55-59 To determine whether the entity's promise to provide a right to access its intellectual property or a right to use its intellectual property, the entity should consider the nature of the intellectual property to which the customer will have rights. Intellectual property is either:

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.
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.

55-60 A customer's ability to derive benefit from a license to symbolic intellectual property depends on the entity continuing to support or maintain the intellectual property. Therefore, a license to symbolic intellectual property grants the customer a right to access the entity's intellectual property, which is satisfied over time (see paragraphs 606-10-55-58A and 606-10-55-58C) as the entity fulfills its promise to both:

a. Grant the customer rights to use and benefit from the entity's intellectual property
b. Support or maintain the intellectual property. An entity generally supports or maintains symbolic intellectual property by continuing to undertake those activities from which the utility of the intellectual property is derived and/or refraining from activities or other actions that would significantly degrade the utility of the intellectual property.

55-62 A license to functional intellectual property grants a right to use the entity's intellectual property as it exists at the point in time at which the license is granted unless both of the following criteria are met:

a. 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 (see paragraphs 606-10-25-16 through 25-18). Additional promised goods or services (for example, intellectual property upgrade rights or rights to use or access additional intellectual property) are not considered in assessing this criterion.
b. The customer is contractually or practically required to use the updated intellectual property resulting from the activities in criterion (a).

If both of those criteria are met, then the license grants a right to access the entity's intellectual property.

55-63 Because functional intellectual property has significant standalone functionality, an entity's activities that do not substantively change that functionality do not significantly affect the utility of the intellectual property to which the customer has rights. Therefore, the entity's promise to the customer in granting a license to functional intellectual property does not include supporting or maintaining the intellectual property. Consequently, if a license to functional intellectual property is a separate **performance obligation** (see paragraph 606-10-55-55) and does not meet the criteria in paragraph 606-10-55-62, it is satisfied at a point in time (see paragraphs 606-10-55-58B through 55-58C).

>>> Example 54—Right to Use Intellectual Property

55-362 Using the same facts as in Case A in Example 11 (see paragraphs 606-10-55-141 through 55-145), the entity identifies four performance obligations in a contract:

a. The software license
b. Installation services
c. Software updates
d. Technical support.

55-363 The entity assesses the nature of its promise to transfer the software license. The entity first concludes that the software to which the customer obtains rights as a result of the license is functional intellectual property. This is because the software has significant standalone functionality from which the customer can derive substantial benefit regardless of the entity's ongoing business activities.

55-363A The entity further concludes that while the functionality of the underlying software is expected to change during the license period as a result of the entity's continued development efforts, the functionality of the software to which the customer has rights (that is, the customer's instance of the software) will change only as a result of the entity's promise to provide when-and-if available software updates. Because the entity's promise to provide software updates represents an additional promised service in the contract, the entity's activities to fulfill that promised service are not considered in evaluating the criteria in paragraph 606-10-55-62. The entity further notes that the customer has the right to install, or not install, software updates when they are provided such that the criterion in 606-10-55-62(b) would not be met even if the entity's activities to develop and provide software updates had met the criterion in paragraph 606-10-55-62(a).

55-363B Therefore, the entity concludes that it has provided the customer with a right to use its software as it exists at the point in time the license is granted and the entity accounts for the software license performance obligation as a performance obligation satisfied at a point in time. The entity recognizes revenue on the software license performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C.

>>> Example 59—Right to Use Intellectual Property

>>>> Case A—Initial License

55-389 An entity, a music record label, licenses to a customer a recording of a classical symphony by a noted orchestra. The customer, a consumer products company, has the right to use the recorded symphony in all commercials, including television, radio, and online advertisements for two years in Country A starting on January 1, 20X1. In exchange for providing the license, the entity receives fixed consideration of $10,000 per month. The contract does not include any other goods or services to be provided by the entity. The contract is noncancellable.

55-390 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity concludes that its only performance obligation is to grant the license. The term of the license (two years), the geographical scope of the license (that is, the customer's right to use the symphony only in Country A), and the defined permitted uses for the recording (that is, use in commercials) are all attributes of the promised license in this contract.

55-391 In determining that the promised license provides the customer with a right to use its intellectual property as it exists at the point in time at which the license is granted, the entity considers the following:

a. The classical symphony recording has significant standalone functionality because the recording can be played in its present, completed form without the entity's further involvement. The customer can derive substantial benefit from that functionality regardless of the entity's further activities or actions. Therefore, the nature of the licensed intellectual property is functional.
b. The contract does not require, and the customer does not reasonably expect, that the entity will undertake activities to change the licensed recording.

Therefore, the criteria in paragraph 606-10-55-62 are not met.

55-392 In accordance with paragraph 606-10-55-58B, the promised license, which provides the customer with a right to use the entity's intellectual property, is a performance obligation satisfied at a point in time. The entity recognizes revenue from the satisfaction of that performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Additionally, because of the length of time between the entity's performance (at the beginning of the period) and the customer's monthly payments over two years (which are noncancellable), the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

>>>> Case B—Renewal of the License

55-392A At the end of the first year of the license period, on December 31, 20X1, the entity and the customer agree to renew the license to the recorded symphony for two additional years, subject to the same terms and conditions as the original license. The entity will continue to receive fixed consideration of $10,000 per month during the 2-year renewal period.

55-392B The entity considers the contract combination guidance in paragraph 606-10-25-9 and assesses that the renewal was not entered into at or near the same time as the original license and, therefore, is not combined with the initial contract. The entity evaluates whether the renewal should be treated as a new license or the modification of an existing license. Assume that in this scenario, the renewal is distinct. If the price for the renewal reflects its standalone selling price, the entity will, in accordance with paragraph 606-10-25-12, account for the renewal as a separate contract with the customer. Alternatively, if the price for the renewal does not reflect the standalone selling price of the renewal, the entity will account for the renewal as a modification of the original license contract.

55-392C In determining when to recognize revenue attributable to the license renewal, the entity considers the guidance in paragraph 606-10-55-58C and determines that the customer cannot use and benefit from the license before the beginning of the two-year renewal period on January 1, 20X3. Therefore, revenue for the renewal cannot be recognized before that date.

55-392D Consistent with Case A, because the customer's additional monthly payments for the modification to the license will be made over two years from the date the customer obtains control of the second license, the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

>>> Example 61B—Distinguishing Multiple Licenses from Attributes of a Single License

55-399K On December 15, 20X0, an entity enters into a contract with a customer that permits the customer to embed the entity's functional intellectual property in two classes of the customer's consumer products (Class 1 and Class 2) for five years beginning on January 1, 20X1. During the first year of the license period, the customer is permitted to embed the entity's intellectual property only in Class 1. Beginning in Year 2 (that is, beginning on January 1, 20X2), the customer is permitted to embed the entity's intellectual property in Class 2. There is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period. There are no other promised goods or services in the contract. The entity provides (or otherwise makes available—for example, makes available for download) a copy of the intellectual property to the customer on December 20, 20X0.

55-399L In identifying the goods and services promised to the customer in the contract (in accordance with guidance in paragraphs 606-10-25-14 through 25-18), the entity considers whether the contract grants the customer a single promise, for which an attribute of the promised license is that during Year 1 of the contract the customer is restricted from embedding the intellectual property in the Class 2 consumer products), or two promises (that is, a license for a right to embed the entity's intellectual property in Class 1 for a five-year period beginning on January 1, 20X1, and a right to embed the entity's intellectual property in Class 2 for a four-year period beginning on January 1, 20X2).

55-399M In making this assessment, the entity determines that the provision in the contract stipulating that the right for the customer to embed the entity's intellectual property in Class 2 only commences one year after the right for the customer to embed the entity's intellectual property in Class 1 means that after the customer can begin to use and benefit from its right to embed the entity's intellectual property in Class 1 on January 1, 20X1, the entity must still fulfill a second promise to transfer an additional right to use the licensed intellectual property (that is, the entity must still fulfill its promise to grant the customer the right to embed the entity's intellectual property in Class 2). The entity does not transfer control of the right to embed the entity's intellectual property in Class 2 before the customer can begin to use and benefit from that right on January 1, 20X2.

55-399N The entity then concludes that the first promise (the right to embed the entity's intellectual property in Class 1) and the second promise (the right to embed the entity's intellectual property in Class 2) are distinct from each other. The customer can benefit from each right on its own and independently of the other. Therefore, each right is capable of being distinct in accordance with paragraph 606-10-25-19(a)). In addition, the entity concludes that the promise to transfer each license is separately identifiable (that is, each right meets the criterion in paragraph 606-10-25-19(b)) on the basis of an evaluation of the principle and the factors in paragraph 606-10-25-21. The entity concludes that it is not providing any integration service with respect to the two rights (that is, the two rights are not inputs to a combined output with functionality that is different from the functionality provided by the licenses independently), neither right significantly modifies or customizes the other, and the entity can fulfill its promise to transfer each right to the customer independently of the other (that is, the entity could transfer either right to the customer without transferring the other). In addition, neither the Class 1 license nor the Class 2 license is integral to the customer's ability to use or benefit from the other.

55-399O Because each right is distinct, they constitute separate performance obligations. On the basis of the nature of the licensed intellectual property and the fact that there is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period, each promise to transfer one of the two licenses in this contract provides the customer with a right to use the entity's intellectual property and the entity's promise to transfer each license is, therefore, satisfied at a point in time. The entity determines at what point in time to recognize the revenue allocable to each performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Because a customer does not control a license until it can begin to use and benefit from the rights conveyed, the entity recognizes revenue allocated to the Class 1 license no earlier than January 1, 20X1, and the revenue on the Class 2 license no earlier than January 1, 20X2.

Excerpt from ASU 2016-10

Determining the Nature of the Entity's Promise in Granting a License

BC56. The Board decided that whether an entity's promise to a customer includes supporting or maintaining the intellectual property to which the customer has rights largely depends on whether the intellectual property has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). An entity's ongoing activities that do not substantively change that functionality may affect the utility of functional intellectual property but would not *significantly* affect its utility. Therefore, continuing to support or maintain the intellectual property is not part of the promise to the customer in transferring a license to functional intellectual property. Functional intellectual property generally includes intellectual property such as software, biological compounds or drug formulas, and completed media content (for example, films, television shows, or music). Patents underlying highly functional items (for example, a patent to a specialized manufacturing process that the customer can employ as a result of the patent regardless of the entity's ongoing activities) also would be functional intellectual property.

BC58. Licenses to functional intellectual property, if separate performance obligations, generally will be satisfied at a point in time. However, the Board included paragraph 606-10-55-62 in this Update because it would have been inconsistent with the broader rationale for the Board's revisions to the licensing guidance to conclude that an entity's expected activities that will (a) substantively change the functionality of functional intellectual property (that is, in a more than minor way) without transferring a good or service to the customer and (b) directly affect the customer because the customer is subject to those changes in functionality (for example, because of contractual or practical restrictions on using an unmodified version of the intellectual property) do not significantly affect the utility of the intellectual property to the customer. In those cases, the entity is, in effect, only granting the customer the right to access its intellectual property in its present form. The customer does not obtain control of the license when it is first granted rights to the intellectual property. This is because when the rights are first granted, the customer obtains rights to intellectual property for which it will not have rights for the full license period and the entity continues to perform throughout the license period by making the changed intellectual property (for example, changed code, content, or design) available to the customer. The Board expects that, at the time of issuance of this Update, the criteria in paragraph 606-10-55-62 will be met only infrequently, if at all. This is because when an entity provides updates to functional intellectual property, the provision of those updates typically is a promised service to the customer and, therefore, the entity's activities involved in providing those updates would not meet the criterion in paragraph 606-10-55-62(a). For example an entity's activities to develop and provide software updates (such as in Example 10, Case C; Example 11; and Example 55) or provide software customization services (Example 11, Case B) would not meet the criterion in paragraph 606-10-55-62(a) because the updates and the customization services are additional promised services to the customer (that is, in addition to the license).

Scope of the licensing guidance

The licensing implementation guidance applies only to software licenses that meet the criteria in paragraph 985-20-15-5. Even if a contract states that a license to software is part of the arrangement, a license does not exist for accounting purposes when those criteria are not met. Instead, the contract is for software-as-a-service (SaaS), to which the licensing implementation guidance does not apply. *Chapter A* – Scope addresses determining whether a contract includes a software license and the application of the criteria in paragraph 985-20-15-5.

Determining whether a software license is distinct

See *Chapter C – Step 2: Identify the performance obligations in the contract.*

Nature of the entity's promise in granting a license drives pattern of revenue recognition

The nature of an entity's promise in granting a license to a customer is to provide the customer with either a:

- right to access the entity's intellectual property (IP); or
- right to use the entity's IP.

The nature of the entity's promise in granting a license:

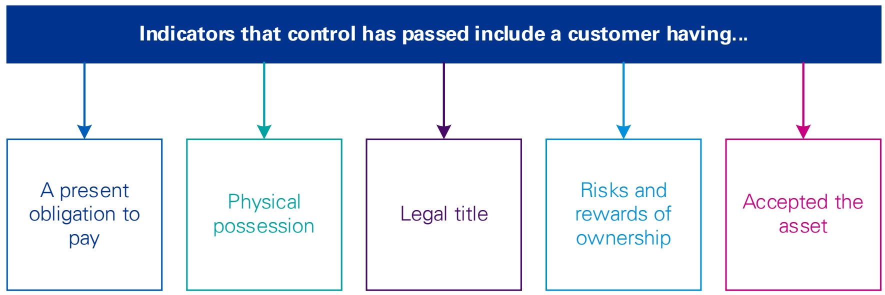
- affects how and when revenue is recognized for a *distinct* license; and
- may affect how and when revenue is recognized for a combined performance obligation that includes one or more licenses. The nature of the entity's promise to the customer in granting the license that comprises part of the performance obligation may affect how the general revenue model is applied to that combined performance obligation. This is because the nature of the entity's promise to the customer in granting the license may affect whether that performance obligation is satisfied over time or at a point in time – i.e. because it may affect whether the customer controls an asset that is being created or enhanced by the entity as the entity performs – *and* will typically affect the measure of progress to the performance obligation if it is satisfied over time.

Pattern of revenue recognition for right to access licenses

A promise to provide the customer with a right to access the entity's IP is satisfied over time because the customer simultaneously receives and consumes benefit from the entity's performance of providing access to its IP as that performance, which includes the entity's activities to continue to support or maintain the licensed IP, occurs. The entity applies the general guidance for measuring progress toward the complete satisfaction of a performance obligation satisfied over time in selecting an appropriate measure of progress.

Pattern of revenue recognition for right to use licenses

A promise to provide the customer with a right to use the entity's IP is satisfied at a point in time. As a starting point in the analysis, the entity applies the general guidance on performance obligations satisfied at a point in time to determine the point in time at which the license transfers to the customer.



However, regardless of consideration of the general point in time transfer of control guidance, revenue cannot be recognized before the beginning of the period during which the customer can use and benefit from the license. This means that revenue attributable to a license is not recognized until the beginning of the license period, regardless of whether a license is an 'initial license' (i.e. the first time the customer has obtained the license) or a license renewal.

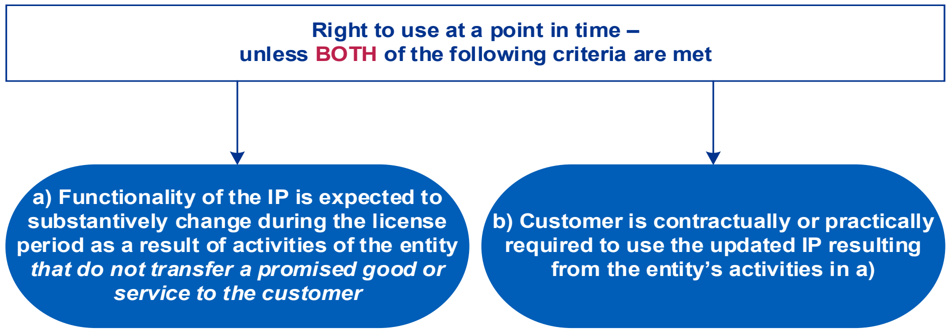
Nature of the entity's promise determined by the nature of the underlying IP

The nature of the entity's promise as either a right to access or a right to use the entity's IP is generally determined by the nature of the underlying IP. Topic 606 segregates IP into two categories:

— **Functional IP** – IP that has significant stand-alone functionality (e.g. the ability to process a transaction, perform a function or task, or be played or aired). Functional IP derives a substantial portion of its utility (i.e. its ability to provide benefit or value) from its significant stand-alone functionality. Examples of functional IP provided by the FASB in the Basis for Conclusions to ASU 2016-10 include software, biological compounds, drug formulas, completed media content and patents underlying highly functional items (e.g. a patent for a specialized manufacturing process).

— **Symbolic IP** – IP that is not functional IP (i.e. IP that does not have significant stand-alone functionality). Because symbolic IP does not have significant stand-alone functionality, substantially all of its utility is derived from its association with the entity's past or ongoing activities, including its ordinary business activities. Examples of symbolic IP provided by the FASB in the Basis for Conclusions to ASU 2016-10 include brands, team or trade names, logos, and franchise rights.

The nature of the entity's promise in granting a license to functional IP is to provide the customer with a right to use the entity's IP unless two criteria are met.



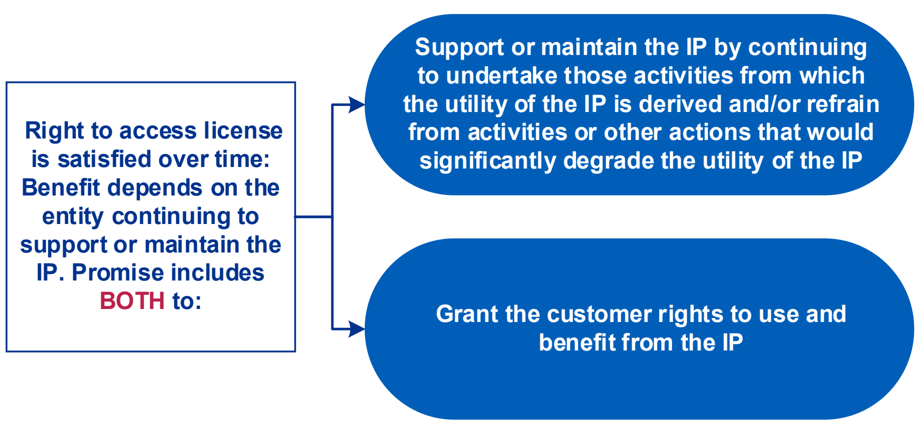
Paragraph 606-10-55-62 further specifies that, when considering the first of the two specified criteria, "additional promised goods or services (e.g. upgrade rights or rights to use or access additional IP) are not considered." The Basis for Conclusions to ASU 2016-10 (BC58) states the FASB's view that these two criteria will be met rarely, if at all. To the date of this publication, examples of scenarios that *would* meet these two criteria have not arisen. Therefore, distinct licenses to functional IP (e.g. software licenses) will almost always provide the customer with a right to *use* the entity's IP.

Conversely, distinct licenses to symbolic IP always provide the customer with a right to *access* the entity's IP. Paragraph 606-10-55-60 explains that this is because the entity's promise to the customer in granting a license to symbolic IP includes *both*:

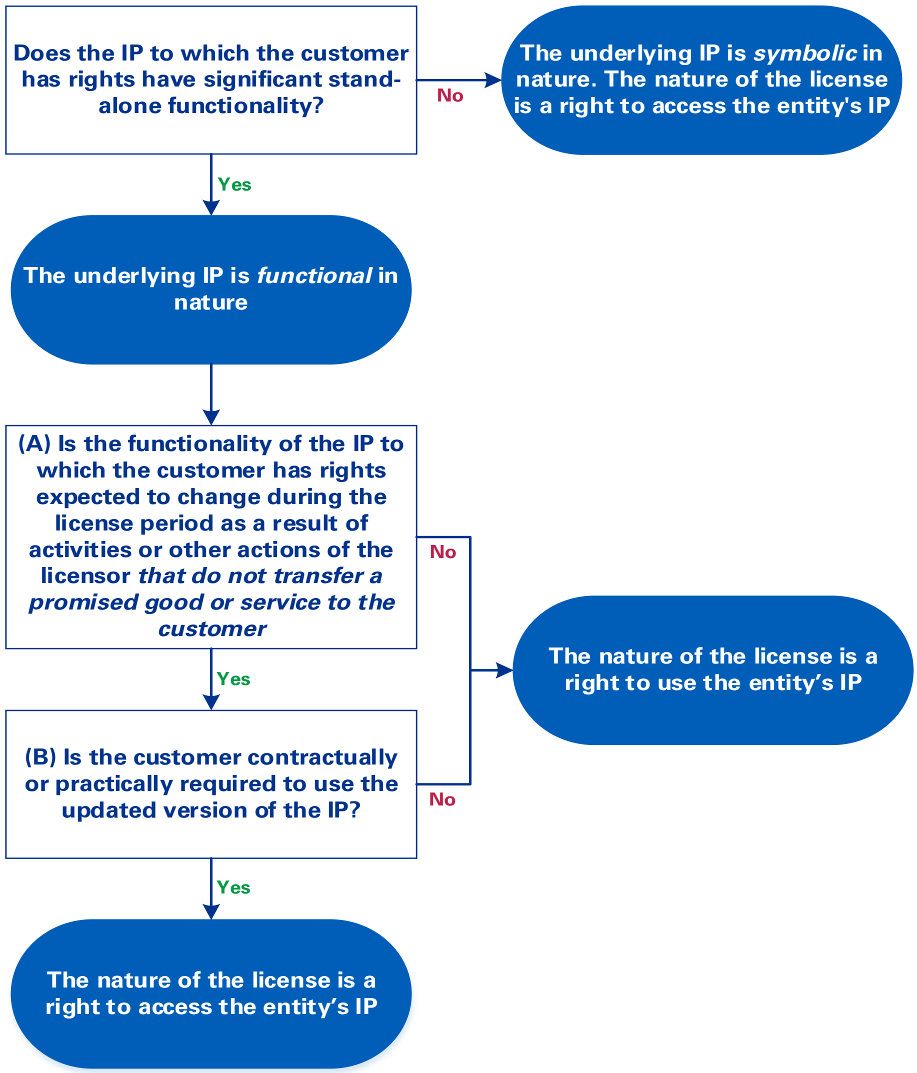
— granting the rights inherent to the license; and

— supporting or maintaining the IP throughout the license period (or the remaining economic life of the IP if that period is shorter than the license period). An entity typically supports or maintains its symbolic IP by continuing to undertake those activities from which the utility of the IP is derived and/or refraining from activities or other actions that would significantly degrade its utility. For example, a professional sports team maintains its team name and logo by continuing to play games and field a competitive team.

Because symbolic IP has limited or no stand-alone functionality, a customer's ability to derive benefit from a license to symbolic IP depends on the entity continuing to support or maintain the IP.



The following decision tree summarizes the evaluation to determine whether a license provides a right to access or a right to use the entity's IP.



Determining the nature of the entity's promise in granting a license when the license is not distinct

When a single performance obligation includes a license of IP and one or more other goods or services, the entity considers the nature of the combined good or service for which the customer has contracted (including whether the license provides a customer with a right to use or right to access the entity's IP) in (a) determining whether that combined good or service is satisfied over time or at a point in time and (b) selecting an appropriate method for measuring progress.

The FASB concluded that not considering the nature of the entity's promise in granting the license that is part of the single performance obligation would result in accounting that does not appropriately reflect the entity's performance, in some cases. For example, if an entity grants a 10-year license that is not distinct from a one-year service arrangement, it would be inappropriate to conclude that the combined performance obligation is satisfied over the one-year service period if the nature of the entity's promise in granting the license would be that of a right to access the entity's intellectual property over the 10-year license period (i.e. satisfied over time) if the license was a separate performance obligation.

Considering the nature of the entity's promise in granting a license that is part of a single performance obligation is part of the overall requirement to determine the nature of the good or service (which may be a combined item, including a combined item that includes a license) in order to determine whether that good or service is satisfied over time or at a point in time and the appropriate measure of progress to apply. It is not a separate step or evaluation.

The FASB included the following examples in the Basis for Conclusions to ASU 2016-10:

— The conclusion that the combined license and customization services performance obligation in Example 11, Case B (paragraphs 606-10-55-146 – 55-150), is completely satisfied over the customized installation service period (i.e. none of the revenue allocated to this performance obligation is recognized after the customization services are complete) depends on the determination, first, that the license provides the customer with a right to use the entity's software. It is only based on that conclusion that, the entity has completely satisfied the single performance obligation by the time the customization of the software is complete. In contrast, *if* the license were deemed a right to access the entity's software (which we do not believe will occur under Topic 606), the entity would adopt a different measure of progress toward complete satisfaction of the performance obligation, recognizing revenue over a longer period and in a different pattern, which would reflect the entity's continuing performance obligation to provide access to the software over the license period after completion of the customized installation services.

— In Example 56, Case A (paragraphs 606-10-55-368 – 55-370), it is only by determining the nature of the entity's promise in granting the license within the single license/manufacturing service performance obligation that the entity can appropriately apply the principle of recognizing revenue when (or as) the entity satisfies its performance obligation to the customer. If the license provides a right to use the entity's drug patent, the entity's performance is complete under the single performance obligation when the manufacturing service is complete. In contrast, if the license were to provide a right to access the entity's drug patent, the performance obligation is not completely satisfied until the end of the license period such that some portion of the transaction price would be recognized after the manufacturing service is complete.
[ASU 2016-10.BC66-BC69]

Comparison to legacy US GAAP

Legacy US GAAP contained industry-specific guidance for licenses of software. For other licenses – e.g. patents, trademarks, copyrights and pharmaceutical/biotechnology applications – and for other intangible assets, there was no specific guidance about whether license revenue should be recognized over the license term or at inception of the license period. SEC guidance applicable to the legacy US GAAP indicated that revenue for licenses of IP is recognized "in a manner consistent with the nature of the transaction and the earnings process".

As a consequence, for licenses for which there is no specific legacy US GAAP guidance, there was diversity in practice as entities evaluated their particular facts and circumstances to conclude what manner of revenue recognition was consistent with the nature of the transaction and the earnings process.

Specifically for software, the guidance on recognition of distinct software licenses is consistent with legacy US GAAP in terms of recognizing revenue for such licenses at a point in time. Legacy US GAAP similarly recognizes revenue for software licenses that are separate elements at a point in time. As outlined in the questions that follow, there may be differences between legacy US GAAP and Topic 606 in terms of at what point in time various software licenses are recognized.

Question F10

Is software functional IP or symbolic IP?

Interpretive response: Functional IP is defined as IP "that has significant stand-alone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired)." Because software has the ability to process transactions or perform specified functions or tasks, it is considered to have significant stand-alone functionality and, therefore, is always functional IP.

The FASB listed software as its first example of functional IP in the Basis for Conclusions to ASU 2016-10, and each example that includes a software license within Topic 606 for which the nature of the underlying software as functional or symbolic IP is enumerated characterizes the software as functional IP.

Question F20

Under what circumstances, if any, does a distinct software license provide the customer with a right to access the entity's IP?

Interpretive response: We are unaware of any circumstances that would result in a distinct software license providing the customer with a right to access the software entity's IP. This is because the licensed software is functional IP (see Question F10) and we are unaware of any fact patterns in which the criteria in paragraph 606-10-55-62 would be met for a distinct license of functional IP (including software licenses).

Paragraph 606-10-55-62 states that a license to functional IP provides the customer with a right to use the entity's IP unless *both*:

a. 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. *Additional promised goods or services (e.g. intellectual property upgrade rights or rights to use or access additional intellectual property) are not considered in assessing this criterion*.

b. The customer is contractually or practically required to use the updated intellectual property resulting from the activities in criterion (a).

Paragraph 606-10-55-62(a), Example 54 in Topic 606 and the Basis for Conclusions to ASU 2016-10 (BC58) each state that a promise to provide updates or upgrades to licensed IP is a promised service in the contract with the customer. Therefore, a software license will *not* meet criterion (a) above solely because the software entity promises to provide specified or unspecified updates, upgrades or enhancements to the customer. A software entity's promise to modify or customize the licensed software would also not meet criterion (a) because the modifications or customizations are a promised service the entity provides to the customer (regardless of whether the modifications or customizations are distinct from the license).

Criterion (b) in paragraph 606-10-55-62 would *also* – i.e. in addition to criterion (a) – not be met in many software licensing arrangements because the customer is frequently not required to install those items. For example, in many software arrangements, a customer that receives updates, upgrades or enhancements is not required to, and often does not, install those items. The customer chooses to forgo installing a particular upgrade or enhancement, often deciding that it is more cost effective to wait until a later version is released. However, even if a customer is *required* to install updates, upgrades or enhancements, criterion (a) would not be met. And because both criteria must be met, the license provides the customer with a right to use the software.

It is also important to note that other potential characteristics of the license (e.g. exclusive vs. non-exclusive, perpetual vs. time-based, and payment terms for the license) will not affect the assessment as to whether a software license provides the customer with a right to use or a right to access the entity's IP.

Question F30

Can a software entity recognize revenue on an initial software license before the commencement of the license term?

Interpretive response: No. Paragraph 606-10-55-58C explicitly states that revenue from a license of IP cannot be recognized before the beginning of the period during which the customer is able to use and benefit from its right to use the licensed IP. The Basis for Conclusions to ASU 2014-09 (BC414) explains that, in the Boards' view, a customer cannot begin to use and benefit from a license before the beginning of the license term.

Therefore, even if the software entity provides a copy of the software to the customer before the beginning of the license term and would otherwise conclude it has transferred control of the license (based on paragraph 606-10-25-30 – see Question F50), the entity is not permitted to recognize the revenue attributable to the software license before the beginning of the license term.

In the case of software license sales to reseller customers, revenue cannot be recognized before the reseller is permitted to sell-on such licenses to *its* customers. A reseller cannot begin to use and benefit from a software license until it is able to resell the license to its customers; therefore, control of a software license does not transfer to a reseller customer before that date.

Comparison to legacy US GAAP

The preclusion of revenue recognition before the beginning of an initial software license term under Topic 606 is consistent with the legacy US GAAP software revenue recognition guidance (paragraphs 985-605-55-101 through 55-104) – i.e. both Topic 606 and legacy US GAAP consider the license undelivered (or not yet transferred) until the initial license term has commenced.

Question F100 highlights the *difference* in timing of recognition for license renewals under Topic 606 as compared to legacy US GAAP.

Question F40

Do physical delivery terms affect when control of a software license transfers to the customer?

Interpretive response: In general, no. Under Topic 606, revenue cannot be recognized for a software license before the customer is able to use and benefit from the software. We do not believe it is possible for the customer to use and benefit from software before it has possession of that software in a physical delivery scenario. Therefore, regardless of whether the software is shipped under FOB shipping point or FOB destination terms, the customer does not obtain control of the software license in that physical delivery scenario before the software is delivered to the customer.

Comparison to legacy US GAAP

Under legacy US GAAP, when physical delivery of the software occurred for accounting purposes frequently drove the timing of revenue recognition for the software license when it was a separate element of the arrangement. In accordance with paragraphs 985-605-55-97 through 55-98 (superseded by ASU 2014-09), the contractual delivery terms were generally respected for accounting purposes – i.e. if Software Entity X shipped the software under

FOB shipping terms on December 31, 20X1, even if Customer C did not receive delivery until January 1, 20X2, delivery was deemed to occur on December 31, 20X1.

Legacy US GAAP did not contain a 'use and benefit' criterion. Consequently, the timing of revenue recognition for distinct software licenses under Topic 606 and the timing of revenue recognition for separate element software licenses under legacy US GAAP may differ in some physical delivery scenarios. It is important to remember, however, that neither legacy US GAAP, nor Topic 606, permits entities to recognize revenue related to time-based (i.e. term) licenses before the beginning of the contractual license term – see Question F30).

Question F50

When has a copy of the software been provided (or otherwise made available) to the customer in an electronic delivery scenario?

Interpretive response: A copy of the licensed software has been provided (or otherwise made available) to the customer at the earlier of when the customer:

— takes possession of the software via a download; and

— has been provided with the access code (or key) that allows the customer to take immediate possession of the software (see Question F60 for further discussion of software access keys and their effect on when the customer is able to begin to use and benefit from a software license).

Comparison to legacy US GAAP

In general, this is consistent with the guidance in, and practice that existed under, legacy US GAAP.

Question F60

How does a requirement to provide a key or access code affect when control of a software license transfers to a customer?

Software authorization codes (or keys)

In a number of software arrangements, entities use authorization codes, commonly referred to as keys, to permit customer access to software that otherwise would be restricted. Keys are used in a variety of ways and may serve different purposes. For example, permanent keys may be used to control access to the software, or additional permanent keys may be necessary for the duplication of the software. Temporary keys may be used for the same purposes and also may be used to enhance the entity's ability to enforce payment or to control the use of software for demonstration purposes.

Interpretive response: In general, if a software key (or access code) is necessary for the customer to take possession of the software or to be able to begin to use the software, the customer will not control the license until that code has been provided.

However, if a key is necessary for the customer to take possession of, or begin to use, the software, but that key has not been provided, the customer is still deemed to have been provided a copy of, and be able to use and benefit from, the software if it has the present, enforceable right to request such key at any time and transfer of such key is effectively administrative or perfunctory – e.g. the entity can generate the key effectively 'on demand'.

Example F60.1
Delivery of software key

ABC Corp. enters into a contract with Customer on June 30, 20X5 to grant a license to Software Product Z for 10 named users. ABC makes the software available for download immediately after the contract is executed, but requires an access key. In accordance with the contract, ABC will provide the access key when Customer provides the list of the 10 named users to ABC. Once the named user list is received, ABC can immediately generate the access key and provide it via email to Customer.

Absent consideration of the software key, ABC would transfer control of the license to Customer on June 30, 20X5 (which is the beginning of the license period). Customer provides the list of named users to ABC, and ABC provides the software key to Customer, on July 10, 20X5.

Despite the fact that ABC does not provide the key until July 10, 20X5, ABC transfers control of the license to Product Z on June 30, 20X5. This is because, even though Customer cannot begin to use the software until the access key is provided, it was within Customer's control to obtain the key at any point in time after the software was made available to Customer for download.

Example F60.2
Temporary access key

ABC Corp. enters into a contract with Customer on January 10, 20X7 to license Software Product A for three years for a nonrefundable fee of $600,000. The fee is to be paid in six equal monthly installments of $100,000, the first installment due when the license term commences on February 1, 20X7. ABC makes the software available for download immediately following contract inception. The payment terms in this contract are customary payment terms for ABC for similar contracts.

ABC has a customary practice of using temporary access keys to enhance the collectibility of payment and, therefore, delivers a temporary key to Customer on February 1, 20X7 that expires in one month. ABC will continue to deliver temporary keys to Customer, each with a term of one month, provided that Customer makes the monthly payments as scheduled. A permanent key will be delivered to Customer upon payment in full of the license fee.

Absent consideration of the software keys, ABC would transfer control of the license to Customer on February 1, 20X7. Assuming Customer does not prepay the license fee, ABC will deliver a permanent access key on July 1, 20X7.

ABC concludes that it transfers control of the license to Product A on February 1, 20X7. The temporary nature of the access keys that will be provided for the first five months of the license term does not affect when control of the license transfers. This is because, assuming Customer fulfills its obligations under the contract (which, in determining there is a contract between the parties, ABC concludes Customer will do so – see *Chapter B – Step 1: Identify the contract with the customer*), transfer of the additional keys after February 1, 20X7 is solely an administrative task.

Fulfillment of that administrative task does not prevent Customer from being able to use and benefit from the Product A software throughout the contracted license term.

Example F60.3
Demonstration of software

ABC Corp. grants Potential Customer access to an FTP site that contains various software products and provides Potential Customer with a temporary key to allow Potential Customer to evaluate each of the products for 30 days. Potential Customer is not obligated to pay for the software until ABC delivers a permanent key. Potential Customer does not owe any fees to ABC for the right to try the software. If Potential Customer chooses to license any of the software products, the license fee is equivalent to the price any similar customer would pay for that license.

Despite the fact that ABC has transferred temporary keys to Potential Customer, until Potential Customer decides to license one or more of the software products, there is no contract between the parties. Potential Customer merely has access to the software for demonstration purposes to allow Potential Customer the ability to evaluate whether it wants to enter into a contract with ABC to license ABC's software.

Example F60.4
Possession of software via download

ABC Corp. enters into a contract with Customer on April 10, 20X2 to grant a license to Software Product G, which is to be delivered to Customer via download from ABC's download portal. ABC emails the Product G access key to Customer on April 10, 20X2. However, at that time due to technical difficulties with ABC's download server, customers cannot access the portal to download the software. Customer is unable to access the portal to commence download of the software until April 12, 20X2.

Although Customer has been provided with the software key on April 10, 20X2, it is not within Customer's control to commence download until April 12, 20X2. Therefore, ABC does not transfer control of the license to Customer until April 12, 20X2 because Customer cannot take immediate possession of the software until April 12, 20X2, when ABC resolved the technical issues.

Comparison to legacy US GAAP

Under legacy US GAAP, an entity was required to have a customary business practice of using temporary keys for collection purposes in order to recognize revenue upon the delivery of the software and the temporary key. Revenue recognition was not appropriate if software and a temporary key were delivered for demonstration purposes (i.e. the customer was not obligated to pay until a permanent key is requested and delivered to the customer).

In general, this is consistent with how we believe temporary keys will affect revenue recognition under Topic 606 as well.

Question F70

Does the use of temporary software keys, rather than a permanent key, change the revenue recognition for a software license?

Interpretive response: As illustrated in Example F60.3 to Question F60, a company may use temporary software keys to permit customers to use the entity's software for trial purposes. In such cases, there is not a contract until the customer enters into a license for that software. However, if an enforceable contract exists granting the customer the right to use the entity's software for a specified period of time (e.g. three years), a software entity would generally not recognize revenue for that software license differently solely depending on whether the entity provides the customer with a permanent key (i.e. good for the entire license period) or provides a series of temporary keys (e.g. providing the customer with a new access key each month or year of the contractual license period).

The entity's provision of temporary keys throughout all or a portion of the license period would generally be considered an administrative task and the entity's choice with respect to use of permanent or temporary keys would not change the parties' enforceable rights and obligations under the contract – i.e. it would not, for example, change the customer's right to use the entity's software for three years into a series of shorter-duration licenses.

Question F80

How should a software entity consider the point-in-time transfer of control indicators in the context of a software license?

Interpretive response: In accordance with paragraph 606-10-55-58B, a software entity applies the performance obligations satisfied at a point-in-time guidance (paragraph 606-10-25-30) to determine at what point in time a distinct software license is transferred to the customer. However, the indicators provided in that guidance are not necessarily intuitive for licensing transactions.

While, in our view, the present right to payment indicator is not affected by the nature of the good being a license, nor is the customer acceptance indicator (see Question F90), the remaining indicators are evaluated somewhat differently from a traditional tangible product or even the *sale* of IP. At least to some extent, we believe the point-in-time control indicators – as they are applied to licenses – are effectively redundant to the guidance in paragraph 606-10-55-58C, which precludes revenue recognition for a software license before both:

— the entity provides (or otherwise makes available) a copy of the software; and
— the customer is able to use and benefit from its right to use the software.

Indicator	License evaluation
The customer has legal title to the asset	Title is generally not transferred for a license; rather the rights conveyed to the licensee are conveyed by the contract. We believe this indicator to be met only once there is an approved contract between the parties *and* the customer obtains the rights to which it is entitled under the contract, which is the point in time that the customer can begin to use and benefit from those rights. The software entity does not complete its performance of transferring those rights (see BC414 in the Basis for Conclusions to ASU 2014-09) before the customer can begin to use and benefit from those rights. Consequently, this indicator is duplicative to the requirement in paragraph 606-10-55-58C(b), which precludes recognition of software license revenue before the customer can begin to use and benefit from the license.
The entity has transferred physical possession of the asset	A software entity does not transfer the software's source code to the customer (even though it may be required to put the source code in escrow – see Question C30); rather, it provides one or more copies of the software to the customer. We believe this indicator is met when the entity provides (or otherwise makes available) the requisite copy of the software.

Indicator	License evaluation
	This indicator is therefore duplicative to the requirement in paragraph 606-10-55-58C(a), which precludes recognition of software license revenue before the entity provides (or otherwise makes available) a copy of the licensed software.
The customer has the significant risks and rewards of ownership of the asset	Because the customer generally would not be able to obtain the significant rewards of the license before it is able to use and benefit from the license, we believe this indicator is also (along with the legal title indicator) generally duplicative to the requirement in paragraph 606-10-55-58C(b).

Consequently, we believe it would be rare for an entity to come to a different conclusion about the point in time a customer obtains control of a software license based on the point-in-time control indicators than it would reach based on the requirements in paragraph 606-10-55-58C. This means that revenue attributable to a distinct software license will be recognized at the later of:

- the beginning of the license period; and
- the point in time a copy of the software is provided or otherwise made available to the customer (see Questions F40 and F50).

Question F90

Can a software entity transfer control of a software license before the customer accepts the software when there are customer-specific acceptance provisions?

Interpretive response: It depends. If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. For example, if a customer acceptance clause related to a licensed software product is based on being able to handle a particular volume of activity or perform a specific function and the entity is able to verify compliance with that specification (e.g. can test the software's performance in a comparable test environment to that of the customer), customer sign-off to that effect is perfunctory and the absence of the customer's formal sign-off will not affect when control of the license transfers to the customer. [606-10-55-86]

In contrast, if the entity cannot objectively determine that the good or service (i.e. the software license) meets the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance. [606-10-55-87]

Example F90.1

Transfer of control of a software license with a customer acceptance provision

ABC Corp. licenses ATM payment processing software to banks. ABC enters into a contract with Bank DEF, a new customer, on September 30, 20X6 to license its standard ATM payment processing software for five years for a fee of $100,000. Bank DEF specifies that the software must be able to process at least 1,000,000 transactions per week. Customer acceptance is indicated by either a formal sign-off or the passage of 90 days without a claim under the acceptance provisions. The $100,000 license fee is due and payable upon the earlier of customer acceptance and the end of the 90-day customer acceptance period. ABC provides a master copy of the software to Bank DEF on October 15, 20X6. The five-year license term begins on December 1, 20X6, which means the 90-day acceptance period ends on February 28, 20X7.

Scenario 1

ABC's software is designed to be able to handle more than 1,000,000 transactions per week, and ABC has multiple customers currently licensing the ATM payment processing software, using a similar configuration as Bank DEF has requested, that have per week transaction volumes in excess of 1,000,000 transactions per week.

Because ABC can objectively determine that it meets the customer acceptance criteria, that criteria does not influence at what point in time ABC transfers control of the software license. Consequently, ABC determines that Bank DEF obtains control of the software license on December 1, 20X6. That date is the later of the date that ABC:

- provides Bank DEF with a copy of the ATM payment processing software; and
- the beginning of the period during which Bank DEF is able to use and benefit from the software.

And while ABC does not yet have a present right to payment for the license at that date, ABC concludes that each of the remaining, applicable point-in-time transfer of control indicators is met by that date – i.e. Bank DEF has (1) the equivalent of legal title to the software license, (2) physical possession of a copy of the ATM software, and (3) the significant risks and rewards of ownership of the license (see Question F80).

Scenario 2

ABC's ATM software has not previously been configured in this fashion or scaled for a customer this size. Consequently, ABC concludes that it is not able, at the point in time Bank DEF would otherwise obtain control of the software license (December 1, 20X6 – see Scenario 1), to objectively determine that the software will meet the agreed-upon specifications.

Consequently, ABC concludes that Bank DEF will not obtain control of the ATM software license until the earlier of (1) customer acceptance sign-off and (2) the end of the 90-day acceptance period, provided the end of the acceptance period is substantive (i.e. ABC does not have a customary business practice of permitting customer rejection of ABC's software or services after the end of the contractually stipulated acceptance period).

Customer acceptance of a license dependent on a distinct service element

A software entity may enter into a contract to sell a software license together with services (e.g. implementation services) that permits the customer to reject the software license if the services are not performed acceptably. In such scenarios, entities should carefully evaluate whether the license and the services are distinct from each other, but the presence of the acceptance provision alone will typically not result in a conclusion that the license and the services are not distinct – i.e. the software entity will still make the determination about whether the license and the services are distinct on the basis of the characteristics of the license and the services. *Chapter C – Step 2: Identify the performance obligations in the contract* addresses considerations about whether a software license and professional services are distinct in further detail.

If the software license and the services are distinct from each other, the acceptance provision related to the services (which includes the ability to reject the software license as well) generally should not affect the timing of transfer of control of the software license. Rather, the acceptance provision that permits the entity to reject the software license should be viewed as a right to return the software license. In these circumstances, the acceptance feature is effectively a subjective right of return (see Question C70).

Comparison to legacy US GAAP

The customer acceptance provisions in Topic 606 are generally consistent with legacy US GAAP. A software entity's considerations under Topic 606 in determining whether it can objectively determine that a good or service meets the agreed-upon specifications in the contract should not differ in any significant manner from that entity's considerations when applying the legacy US GAAP software guidance (paragraphs 985-605-55-80 and 55-81) and SEC guidance (SEC SAB Topic 13).

Question F100

Can a software entity begin recognizing revenue on a distinct software license renewal before the commencement of the renewal term?

Interpretive response: No. Topic 606 does not make a distinction between a license that is for a renewal term and one that is for an initial term; and therefore, consistent with the answer to Question F30 about initial software licenses, revenue attributable to a software license renewal cannot be recognized before the start of the applicable renewal period. Topic 606 explicitly states that control cannot transfer for a license before the beginning of the period during which the customer can use and benefit from the intellectual property.

Often, a contract for a software license renewal includes additional performance obligations (e.g. additional software licenses or services) other than the renewed software license. In such cases, the entity would apply the guidance in *Chapter C – Step 2: Identify the performance obligations in the contract*, *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*, and/or *Chapter G – Contract modifications* in order to determine whether the additional products or services are separable from the renewal license, and if so, how to allocate the transaction price in the contract to the separate performance obligations.

Example F100.1

Renewal license and bundled PCS

ABC Corp. currently licenses software Product A to Customer under a multi-year time-based license that extends through December 31, 20X4. Product A is functional IP and, consistent with Question F20, the license to Product A was determined to provide Customer with a right to use Product A.

ABC also currently provides PCS to Customer that is auto-renewed annually if Customer has an active license to Product A unless PCS is canceled by Customer. The software license and the PCS are separate performance obligations, and ABC has an observable stand-alone selling price for its annual Product A PCS and estimates the stand-alone selling price for its Product A licenses using the residual approach.

On September 30, 20X4, ABC executes a license renewal that entitles Customer to use the software for an additional two-year period commencing on January 1, 20X5 and extending through December 31, 20X6 and also provides for one year of bundled PCS (from January 1, 20X5 to December 31, 20X5) for a total fixed contract price of $1,000. The observable stand-alone selling price of the PCS is $200, which results in an estimated stand-alone selling price of $800, using the residual approach, for the Product A renewal license.

ABC does not recognize the $800 allocated to the renewal license until January 1, 20X5 (i.e. when the customer obtains the right to use and benefit from that license). The $200 in transaction price allocable to the PCS performance obligation is recognized over time as the PCS is provided (from January 1, 20X5 to December 31, 20X5).

Comparison to legacy US GAAP

While the timing of revenue recognition for initial software licenses is effectively unchanged from legacy US GAAP to Topic 606, the guidance in

Topic 606 differs from that in legacy US GAAP with respect to software license renewals (or extensions).

Under legacy US GAAP (paragraphs 985-605-55-105 through 55-114), the portion of the arrangement fee allocable to the renewal of an active license was recognized before commencement of the renewal term, provided that all of the other revenue recognition criteria in Subtopic 985-605 had been met (i.e. evidence of the renewal arrangement exists, the renewal fee is fixed or determinable, and collectibility of the renewal fee is probable). This included that the software vendor had vendor-specific objective evidence of fair value (VSOE) over any other elements bundled with the license renewal (e.g. PCS or hosting services). Under legacy US GAAP, because the software had previously been delivered (i.e. with the initial license), revenue recognition was only subject to meeting the remaining revenue recognition and separation criteria.

In contrast, Topic 606 states that revenue from a license, including a renewal license, cannot be recognized before the beginning of the period during which the customer can use and benefit from the software license even if a copy of the software has already been delivered.

Example	Legacy US GAAP	Topic 606
Three-year term license that commences on 1/1/X1; on 6/30/X3 both parties agree to extend the license for two years effective 1/1/X4.	In general, assuming the other applicable revenue recognition criteria have been met, the license fee is recognized as revenue on 6/30/X3.	The renewal license fee is recognized on 1/1/X4, when the two-year extension period begins.

Question F110

When does control of a distinct software license transfer to the customer in a hosting arrangement?

Interpretive response: In a software licensing arrangement where the entity will host the licensed software, the entity may not provide (or otherwise make available) a copy of the licensed software unless and until the customer communicates its intention to exercise its contractual right to take possession of the software. Consequently, because paragraph 606-10-55-58C(a) states that revenue cannot be recognized before the entity "provides (or otherwise makes available) a copy of the intellectual property to the customer," the question arises as to when the entity transfers control of a software license in a hosting arrangement.

Other than with respect to providing (or otherwise making available) a copy of the licensed software, the considerations for when control of a software license transfers to the customer in an arrangement that includes hosting services are not different from the considerations for other software licensing arrangements.

As for when the entity provides (or otherwise makes available) to the customer a copy of the licensed software, we believe the criterion (paragraph 606-10-55-58C(a)) is met when the hosting services commence provided that, at that point in time, either (1) the customer has the enforceable right and ability to download the software or (2) the entity has a present enforceable obligation to provide the software key or access code necessary for the customer to download the software upon demand of the customer. This is because if at least one of those criteria is met it is within the *customer's* control to take possession of the software – i.e. to obtain a copy of the licensed software. Consistent with the underlying logic in Example F60.1, it would be counter-intuitive to the concept of control to preclude or delay revenue recognition for an event that is solely within the control of the customer.

Question F120

If a software entity contracts with a customer for a license to a specified software product that is not yet available for release, has the entity transferred control of the license if it makes available a substantially equivalent software product (including a limited-release or beta version of the soft-ware) with the promise to deliver the specified software product once it is ready for distribution?

Software product that has not yet been through the entity's normal quality assurance process

A customer may wish to license a newer version of an entity's software product that has not yet been made available for general release or distribution. In some cases, the entity may deliver a limited-release (e.g. beta) version of a product that is in the latter stages of development to be used by the customer until development of the product is completed (including the entity's normal quality assurance process) and the software is made available for general release. In such arrangements, there is typically an implied (or contractual) obligation for the entity to deliver the final product when the quality assurance process is complete and the software is made available for general release.

Interpretive response: In general, if the software entity and the customer contract for a license to a specified software product, control of the software license does not transfer until *that* software product is made available to the customer. That is, making available a *different* software product (i.e. one with more than minimal differences in features and/or functionality – see Question C80) from that promised to the customer in the contract would generally mean the entity has not fulfilled its performance obligation to transfer a license to the contracted software product. However, transferring a license to the substitute software product would likely have at least some value to the customer such that a portion of the transaction price would be allocated to that license.

However, we believe certain facts and circumstances could result in a different conclusion. For example:

— Some customers request an early-release version of the software (e.g. an alpha or beta version) if the contracted software is not yet available for commercial release, and having access to the early-release version will provide them substantive benefit. For example, this may be because the customer will use the software as a component to its own products and having access to the early-release version will permit the customer to concurrently advance development of its own products, rather than waiting for commercial release of the software. In these cases, the contract may, explicitly or implicitly, contain a promise to transfer a license to the early-release version as well as a promise to provide a specified upgrade – i.e. to the contracted version (e.g. commercial release version) of the software. Control of the license to the early-release version would transfer in the same manner as any other software license, while a portion of the transaction price would be allocated to the specified upgrade and recognized only when that specified upgrade is made available to the customer. It is important in arrangements of this nature to consider whether the customer has an enforceable right to use the early-release version and the entity an enforceable obligation to provide both that early-release version and the commercial release version, as well as to consider whether the provision of the early-release version is substantive (i.e. has a valid commercial purpose).

  In some arrangements of this nature, the customer will also have an unspecified upgrade right to obtain development versions produced in between transfer of the early-release version and release of the contracted version. For example, the customer may first obtain an alpha version of the software, but have rights to an unspecified number of additional releases that will come after the alpha version, but before commercial release of the software. Entities should be aware that this would also be an additional promise to the customer in the contract and that they will need to evaluate whether each promised good or service is distinct (Questions C170 and C340 discuss considerations about whether unspecified and specified upgrades, respectively, are distinct from a software license).

— If the entity delivers a substitute software product with no more than minimal differences in features and/or functionality from the software product for which the customer has contracted, the software entity could conclude that the right to the contracted software is solely an exchange right, and therefore, that it has transferred control of the software license when it makes available the substantially equivalent limited-release version of the software (i.e. provided the other transfer of control requirements have been met).

— If the customer will retain rights to use a substitute software product after it receives the contracted software product (i.e. the customer will have rights to use two different software products – Question C340 includes considerations in evaluating whether an item is an upgrade/enhancement or an additional software product), this would generally mean the customer is obtaining two licenses and the entity would separately consider when control of each license transfers to the customer.

Example F120.1
Early release version of software product

ABC Corp. and Customer enter into a contract for Customer to license the commercial release version of Software Product G for four years; however, Product G is not yet available for commercial release. Commercial release of Product G is not expected for approximately six months; however, ABC presently has an alpha version of the software developed. Customer requests ABC to provide the alpha version in the interim; this is because access to the early-release version will permit Customer to accelerate its own product development that makes use of ABC's software. ABC agrees and also commits to provide interim versions of the software that are developed between the alpha version and the commercial release version. Provision of the alpha version before commercial release does not change the overall term of the license to the commercial release version of the software – i.e. the four-year term of the license to the specified commercial release version still commences upon transfer of the commercial release version. Therefore, the period during which Customer has rights to use pre-commercial release versions of the software is incremental to the four-year term and will commence when the alpha version license is transferred to Customer (see next paragraph).

ABC delivers a copy of the alpha version to Customer on January 31, 20X5 and Customer is permitted to use the software immediately. ABC delivers the commercial release version to Customer on August 10, 20X5; and during the intervening period, ABC provided Customer with two interim releases, including the beta version. At contract inception, ABC could not predict how many interim releases would be provided to Customer before the commercial release version or when they would be provided.

ABC concludes that the contract includes four promised goods and services:

- a license to the alpha version of the software;
- a promise to provide a specified upgrade to the software – i.e. to the commercial release version of the software;
- a promise to provide when-and-if available upgrades to the software throughout both (a) the period between transfer of the alpha version and transfer of the commercial release version and (b) the four-year commercial release license period; and
- technical support services that will be provided throughout both (a) the period between transfer of the alpha version and transfer of the commercial release version and (b) the four-year commercial release license period.

ABC concludes that there is a license granted to the alpha version of the software because Customer requested and ABC agreed to provide Customer with the right to use the alpha version and to provide the commercial release version later when available. ABC concludes that the software license to the alpha version is transferred to Customer on January 31, 20X5, which is the date the software is made available to Customer and Customer can begin to use and benefit from it.

ABC concludes that its promise to transfer the commercial release version of the software (the specified upgrade) is satisfied on August 10, 20X5 when it is provided to the customer.

Consistent with the discussion in Question C130, ABC concludes the unspecified upgrade right and the technical support services are stand-ready obligations that ABC will satisfy over time. Because the number and timing of the upgrades and support needs is uncertain, ABC concludes that it is appropriate to use a time-elapsed output measure of progress to recognize the revenue allocated to those performance obligations, consistent with the pattern of benefit to the customer of those services.

Comparison to legacy US GAAP

When an entity delivered a limited release version of software and an implied or contractual obligation existed to deliver a final general release, the delivery criterion of the legacy US GAAP software revenue recognition guidance was not considered met; and therefore, revenue was not recognized upon delivery of the limited-release version of the software, even if the entity had received payment, because the entity had not yet delivered the final product that the customer ordered. Revenue would be recognized when the final product was delivered, provided that all of the other software revenue recognition criteria had been met at that point (note that in Example F120.1, because the license and the PCS are co-terminus, the entity would not have had VSOE of fair value for that PCS and revenue for the entire arrangement would have been recognized ratably from the time the specified upgrade was delivered until the end of the four-year license period).

Based on the discussion above, we believe entities are likely to recognize revenue sooner than they did under legacy US GAAP, both because of the differences in the separation guidance (i.e. not needing VSOE for the specified upgrade, the technical support or the unspecified upgrade rights) and the delivery guidance (i.e. the conclusion under legacy US GAAP that delivery of the limited release version of the software did not constitute delivery of a software product). Specifically, in the case where the substitute product has no more than minimal differences from the contracted product, the amount allocated to the software license may be recognized earlier than under legacy US GAAP. Meanwhile, in a scenario where the entity is deemed to grant the customer a license to an early-release version and a specified upgrade, or a license to the substitute product and a license to the contracted software product, the portion of the total revenue allocated to the early-release license or the substitute product license will generally be recognized earlier than revenue was permitted to be recognized under legacy US GAAP because revenue under legacy US GAAP would have been deferred until the contracted software was delivered.

Question F125

Does granting price concessions to resellers/distributors affect whether control has transferred?

Interpretive response: No. Granting price concessions does not affect whether an entity transfers control of a good or service. However, a pattern of granting price concessions to resellers/distributors may affect the transaction price, which is determined in Step 3 (see Question D130).

Revenue recognition for software-as-a-service and services that are software-related

Excerpt from ASC 606-10

> Satisfaction of Performance Obligations

25-23 An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

25-24 For each performance obligation identified in accordance with paragraphs 606-10-25-14 through 25-22, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 606-10-25-27 through 25-29) or satisfies the performance obligation at a point in time (in accordance with paragraph 606-10-25-30). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

25-25 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

a. Using the asset to produce goods or provide services (including public services)
b. Using the asset to enhance the value of other assets
c. Using the asset to settle liabilities or reduce expenses
d. Selling or exchanging the asset
e. Pledging the asset to secure a loan
f. Holding the asset.

25-26 When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the asset (see paragraphs 606-10-55-66 through 55-78).

25-27 An entity transfers control of a good or service over time and, therefore, satisfies a **performance obligation** and recognizes **revenue** over time, if one of the following criteria is met:

a. The **customer** simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6).
b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7).
c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph 606-10-25-28), and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29).

25-28 An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the **contract** approve a contract modification that substantively changes the performance obligation. Paragraphs 606-10-55-8 through 55-10 provide guidance for assessing whether an asset has an alternative use to an entity.

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

>> Performance Obligations Satisfied Over Time

55-4 In accordance with paragraph 606-10-25-27, a performance obligation is satisfied over time if one 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 (see paragraphs 606-10-55-5 through 55-6).
b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7).
c. The entity's performance does not create an asset with an alternative use to the entity (see paragraphs 606-10-55-8 through 55-10), and the entity

has an enforceable right to payment for performance completed to date (see paragraphs 606-10-55-11 through 55-15).

>>> Simultaneous Receipt and Consumption of the Benefits of the Entity's Performance (paragraph 606-10-25-27(a))

55-5 For some types of performance obligations, the assessment of whether a customer receives the benefits of an entity's performance as the entity performs and simultaneously consumes those benefits as they are received will be straightforward. Examples include routine or recurring services (such as a cleaning service) in which the receipt and simultaneous consumption by the customer of the benefits of the entity's performance can be readily identified.

55-6 For other types of performance obligations, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. In those circumstances, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially reperform the work that the entity has completed to date if that other entity were to fulfill the remaining performance obligation to the customer. In determining whether another entity would not need to substantially reperform the work the entity has completed to date, an entity should make both of the following assumptions:

a. Disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity
b. Presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

>>> Customer Controls the Asset As It Is Created or Enhanced (paragraph 606-10-25-27(b))

55-7 In determining whether a customer controls an asset as it is created or enhanced in accordance with paragraph 606-10-25-27(b), an entity should apply the guidance on control in paragraphs 606-10-25-23 through 25-26 and 606-10-25-30. The asset that is being created or enhanced (for example, a work in process asset) could be either tangible or intangible.

>>> Entity's Performance Does Not Create an Asset with an Alternative Use (paragraph 606-10-25-27(c))

55-8 In assessing whether an asset has an alternative use to an entity in accordance with paragraph 606-10-25-28, an entity should consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different **customer**. The possibility of the **contract** with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.

55-9 A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset not to have an alternative use to the entity. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. In contrast, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the entity could transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract.

55-10 A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss could arise because the entity either would incur significant costs to rework the asset or would only be able to sell the asset at a significant loss. For example, an entity may be practically limited from redirecting assets that either have design specifications that are unique to a customer or are located in remote areas.

>>> Right to Payment for Performance Completed to Date (paragraph 606-10-25-27(c))

55-11 In accordance with paragraph 606-10-25-29, an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the **customer** or another party terminates the **contract** for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the **performance obligation** plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

a. A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)
b. A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

55-12 An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed-upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity should consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.

55-13 In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

55-14 In assessing the existence and enforceability of a right to payment for performance completed to date, an entity should consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:

a. Legislation, administrative practice, or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer.
b. Relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect.
c. An entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

55-15 The payment schedule specified in a contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the payment schedule in a contract specifies the timing and amount of consideration that is payable by a customer, the payment schedule might not necessarily provide evidence of the entity's right to payment for performance completed to date. This is because, for example, the contract could specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract.

For each performance obligation in a contract, an entity first determines whether the performance obligation is satisfied over time – i.e. control of the good or service transfers to the customer over time.

If the performance obligation is other than a distinct license of IP and one or more of the following criteria are met, then the performance obligation is satisfied over time. The entity, therefore, recognizes revenue over time, using a method that depicts its performance – i.e. the pattern of transfer of control of the good or service to the customer.

	Criterion	Example
1	The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs	Routine or recurring services – e.g. SaaS or technical support services
2	The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced	Developing software the customer will host such that the development costs are capitalizable by the customer in accordance with Subtopic 350-40, Internal-Use Software
3	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	Customizing software specifically for a customer's needs that cannot be transferred to other customers and the entity has a right to reimbursement for its costs plus a reasonable margin throughout the customization period if the contract were to be terminated

Comparison to legacy US GAAP

Under legacy US GAAP, if an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification or customization of software, the entire arrangement is accounted for in accordance with the guidance in Subtopic 605-35 for construction- and production-type contracts.

Arrangements accounted for under Subtopic 605-35 are accounted for under the percentage-of-completion method or completed contract method. For other service contracts, revenue from services is generally recognized over time using the proportional performance or straight-line method.

Under Topic 606, an entity currently applying these methods can continue to recognize revenue over time only if one or more of the three criteria are met. Unlike legacy industry- and transaction-specific guidance, the requirements in Step 5 of the model to determine if a performance obligation is satisfied over time are not a matter of scope, but rather are applied to each performance obligation in the contract. When applying the Topic 606 criteria, some entities may determine that revenue currently recognized at a point in time should be recognized over time, or vice versa.

Customer receives and consumes benefits as the entity performs

A customer obtains the benefits of an entity's performance as the entity performs if another entity would not need to substantially reperform work the entity has completed to date if that other entity were to fulfill the remaining performance obligation to the customer.

In evaluating this criterion, an entity would disregard potential limitations (whether contractual or practical) that would prevent it from transferring a remaining performance obligation to another entity. This is because the objective of the criterion is to determine whether control of the goods or services has already been transferred to the customer by using a hypothetical assessment of what another entity would need to do if it were to take over the remainder of the performance obligation.

The Boards observed that this criterion is not intended to apply to contracts in which the entity's performance is not immediately consumed by the customer, which would be typical in cases where the entity's performance results in an asset (e.g. work in process). Consequently, entities that have contracts in which the entities' performance results in an asset (which could be intangible) being created or enhanced should consider the second criterion.

Entity's performance creates or enhances an asset the customer controls as the entity performs

In evaluating whether a customer controls an asset as it is created or enhanced, an entity considers the guidance on control in Topic 606, including the transfer of control indicators.

The Boards created this criterion to address situations where an entity's performance creates or enhances an asset that a customer clearly controls as the asset is created or enhanced. As the customer controls any work in process, the customer is obtaining the benefits of the goods or services that the entity is providing.

There may be cases for some performance obligations in which it is unclear whether the asset that is being created or enhanced by the entity is controlled by the customer. Consequently, it may be more challenging to determine when control transfers and, therefore, an entity should evaluate the third criterion.
[ASU 2014-09.BC131]

Entity's performance does not create an asset with alternative use and entity has an enforceable right to payment

The third criterion that, if met, results in a performance obligation being satisfied over time contains two parts:

1. whether the entity's performance creates an asset that does *not* have an alternative use to the entity; and
2. the entity has an enforceable right to payment for performance completed to date (while expecting to fulfill the contract as promised).

The Boards observed that this criterion may be necessary for services that may be specific to a customer (e.g. consulting services that result in a professional opinion for the customer) or for the creation of a tangible (or intangible) good.

If an asset that an entity is creating has no alternative use to the entity, the entity is effectively constructing an asset at the direction of the customer. Consequently, the entity will want to be economically protected from the risk of the customer terminating the contract and leaving the entity with no asset or an asset that has little value to the entity. That protection is established by requiring that, at all times, if the contract is terminated for reasons other than the entity's failure to perform in accordance with the terms of the contract, the customer must pay for the entity's costs plus a margin that is reasonable in light of the performance completed to date. Payment for the entity's costs plus a reasonable margin on performance completed to date does not necessarily require that the customer pay an amount directly proportional to the entity's performance completed to date – e.g. it may not be required that to meet this criterion, the customer must pay 25% of the transaction price if the contract is terminated when the entity is 25% complete. The fact that the customer is obliged to pay for the entity's performance (or in other words is unable to avoid paying for that performance) at all times during the contract (coupled with the fact that the asset has no alternative use to the entity) means that the customer has obtained the benefits from the entity's performance. [ASU 2014-09.BC142]

No alternative use

An asset may not have an alternative use to the entity due to contractual restrictions. In such cases, the contractual restrictions must be substantive – i.e. an enforceable right. For example, a software entity may be precluded from transferring a customized functionality developed for a specific customer to other customers. In contrast, if an asset is largely interchangeable with other assets and could be transferred to another customer without breaching the contract or incurring significant incremental costs, then the restriction is not substantive.

An asset also may not have an alternative use due to practical restrictions or limitations. A practical limitation on an entity's ability to direct an asset for another use – e.g. software customizations that are unique to a customer – exists if the entity would:

- incur significant costs to rework the asset; or
- be able to sell the asset only at a significant loss.

When evaluating practical restrictions or limitations, an entity considers:

- the characteristics of the asset that will ultimately be transferred to the customer; and
- whether the asset, *in its completed form*, could be redirected without a significant cost of rework.

The focus in this assessment is not on whether the asset can be redirected to another customer or for another purpose during the production process – e.g. up until the point at which customization of the asset begins to occur. For example, in some manufacturing contracts the basic design of an asset may be the same across many contracts, but the customization of the finished good may be substantial. Consequently, redirecting the asset in its completed state to another customer would require significant rework.

Protective rights – e.g. a customer having legal title to the goods in a contract – may not limit the entity's practical ability to physically substitute or redirect an asset, and therefore, on their own, are not sufficient to establish that an asset has no alternative use to the entity.

The assessment of whether an asset has an alternative use is made at contract inception and is not subsequently updated, unless a contract modification substantially changes the performance obligation.

Enforceable right to payment

An entity that is constructing an asset with no alternative use is effectively constructing the asset at the direction of the customer. The contract will often contain provisions providing some economic protection against the risk of the customer (or another party) terminating the contract and leaving the entity with an asset of little or no value.

Similarly, an entity that is providing a customer-specific service (e.g. a consulting service specific to a customer's business), rather than constructing an asset, will often require the contract to contain provisions that compensate the entity for its efforts in the event the customer or another party terminates the contract before completion (e.g. before the entity issues the final report or communicates the findings).

The presence of an enforceable right to payment for performance completed to date supports the conclusion that the entity's performance does not create an asset with alternative use and also supports that the entity is transferring value to the customer over time as it performs (i.e. that it is satisfying its performance obligation over time).

In assessing whether an enforceable right to payment exists, the entity considers whether, throughout the contract, it is entitled to compensation for performance completed to date if the contract were terminated for reasons other than the entity's failure to perform as promised. In addition to evaluating contract terms, an entity would also consider the effect of Uniform Commercial Code (UCC) provisions and relevant case law in assessing whether an enforceable right to payment exists. When the payment terms upon termination are silent, see Question F201 for guidance.

The entity's right to payment may not always be for the contract value in a prematurely terminated contract. However, the compensation should be based on a reasonable proportion of the entity's expected profit margin to date – e.g. a right to recover costs incurred plus a reasonable profit margin. The entity's determination of the expected profit margin is made at contract inception. Similarly, the amount to which the entity is entitled does not need to equal the contract margin at all times during the arrangement (i.e. a pro rata amount directly proportional to the entity's completed performance to the date of termination), but has to be based on either a reasonable proportion of the entity's expected profit margin for the contract based on the work performed to date or a reasonable return on the entity's cost of capital for similar contracts.

If an entity would only recover its costs in an otherwise profitable contract, it would not have the right to payment for performance completed to date. When evaluating termination provisions in contracts priced at a loss, see Question F204 for guidance.

Other factors to consider include the following.

Payment terms	— An unconditional right to payment is not required, but rather an enforceable right to demand or retain payment for the performance completed to date if the contract is terminated by the customer for convenience
Payment schedule	— A payment schedule does not necessarily indicate whether an entity has an enforceable right to payment for performance to date
Contractual terms	— If a customer acts to terminate a contract without having a contractual right at that time to do so, then the contract terms may entitle the entity to continue to transfer the promised goods or services and require the customer to pay the corresponding consideration promised
Legislation or legal precedent	— If a right is not specified in the contract, jurisdictional matters such as legislation, UCC, administrative practice or legal precedent may confer a right to payment to the entity. For considerations when evaluating contracts that do not specify the payment terms at termination, see Question F201. — In contrast, legal precedent may indicate that rights to payment in similar contracts have no binding legal effect, or that an entity's customary business practice not to enforce a right to payment may result in that right being unenforceable in that jurisdiction

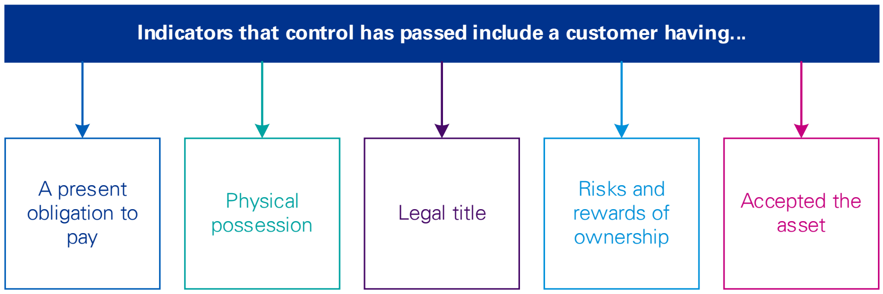
Comparison to legacy US GAAP

The basis for using the percentage-of-completion method for construction- and production-type contracts in the scope of Subtopic 605-35 was that in many cases the contractor had, in effect, agreed to sell its rights to work in progress as the work progresses. Accordingly, the parties had effectively agreed to a continuous sale that occurred as the contractor performed. This rationale is similar to the second over-time criterion in Topic 606 – that control of a good or service is transferred over time if the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.

However, the first and third over-time criteria in Topic 606 will require an entity to think differently about the satisfaction of performance obligations. In general, the effect of applying the new criteria will vary depending on the relevant facts and circumstances, and differences in contract terms could result in different assessment outcomes. These different assessments could create significant differences in the timing or pattern of revenue recognition under Topic 606.

If none of the over-time criteria are met

If none of the over-time criteria are met, then control transfers to the customer at a point in time and the entity recognizes revenue at that point in time. That point in time is determined considering both the principle for control and five indicators:



Question F130

Is a performance obligation to provide software-as-a-service satisfied over time?

Interpretive response: In general, yes. The customer will typically consume and receive benefit throughout the contract period from the SaaS provider's performance of providing access to its hosted software – i.e. the customer in a SaaS arrangement receives benefit throughout the arrangement period from having the ability to access the hosted software as needed. This is consistent with similar arrangements, such as a consumer in a telecommunications arrangement; the consumer in a home cable or satellite television/internet arrangement typically receives benefit throughout the arrangement period from its ability to make use of the services (e.g. watch television or access the internet) when desired.

Example F130.1

Software-as-a-service

SaaS Provider enters into a contract with Customer to provide Customer with access to its hosted research application for three years on a SaaS basis – i.e. assume Customer does not have the right to take possession of the hosted software. There are no other promised goods or services in the contract.

SaaS Provider concludes that its performance obligation to provide SaaS is satisfied over time on the basis that Customer receives and consumes benefits from SaaS Provider's performance of providing access to the hosted application as SaaS Provider performs – i.e. Customer benefits from having the research tool available to it whenever needed during the arrangement period.

Question F140

Are hosting services provided in a software licensing arrangement satisfied over time?

Interpretive response: In general, yes. The customer will typically consume and receive benefit throughout the hosting period from the entity's performance of hosting and providing access to the hosted software, which the customer would otherwise have to undertake itself or obtain another party to do.

Question F150

Is a performance obligation to provide technical support services satisfied over time?

Interpretive response: Technical support is typically a 'stand-ready obligation' (see Question C130), rather than a promise to provide a specified number of support activities, which could be the case if the contract permits the customer only a specified number of support calls over a specified period of time and that number of calls is substantive – i.e. it is not, for example, significantly in excess of any expectation of customer activity.

If technical support is a stand-ready obligation, it will generally be satisfied over time because the customer will consume and receive benefit from the entity's resources standing ready to provide technical support when and as-needed throughout the support period (subject to the contract's terms, such as availability only on weekdays and/or during specified hours of the day) as the entity performs by maintaining its support infrastructure (e.g. helpdesk or call center, online support FAQs, web desk).

However, if technical support is, instead, an obligation to provide a specified number of support calls, the entity would generally recognize revenue as the customer makes use of the specified calls, subject to considerations of breakage.

Example F150.1

Technical support services

ABC Corp. and Customer enter into a contract for Customer to license Software Product H and for ABC to provide technical support for the full three-year license period. The terms of the support agreement specify that ABC's helpdesk and web support operators are available from 8am - 5pm each day other than Sundays; while ABC's web page providing support FAQs as well as other 'helpful hints' is available 24/7.

Consistent with Question C160, ABC concludes that the software license and the technical support services are distinct from each other and, therefore, separate performance obligations.

The distinct software license is satisfied at a point in time (see Question F20). Meanwhile ABC concludes that the technical support services are satisfied over the three-year technical support period on the basis that the technical support is a 'stand-ready obligation' such that Customer consumes and receives benefit from having access to ABC's support resources, when and as needed, throughout the three-year support period as ABC performs by maintaining its support infrastructure (e.g. website, helpdesk) and making that available to Customer in accordance with the terms of the support agreement.

Question F160

Is a performance obligation to provide unspecified updates, upgrades and enhancements satisfied over time?

Interpretive response: Question C130 in *Chapter C – Step 2: Identify the performance obligations in the contract* concludes that a promise to provide unspecified updates, upgrades and enhancements is a 'stand-ready obligation' *when* the nature of the entity's promise is to transfer an undefined number of updates, upgrades or enhancements (i.e. any and all) that are developed during the support period.

When a promise to provide unspecified updates, upgrades and enhancements is a 'stand-ready obligation', the customer consumes and receives benefits throughout the period for which it is entitled to those items. As described by the FASB staff in TRG Agenda Paper No. 16 prepared for the January 2015 TRG meeting, the customer benefits throughout the support period from the assurance that any updates, upgrades or enhancements developed by the entity during the period will be made available and, therefore, the performance obligation to provide those items is satisfied over time. At the January 2015 TRG meeting, TRG members generally agreed that a time-based (i.e. straight-line) measure of progress is not always appropriate for a stand-ready obligation, including a promise to provide unspecified updates, upgrades and enhancements. Question F220 discusses when a measure of progress other than one that is time-based would be appropriate for a stand-ready obligation to provide unspecified updates, upgrades and enhancements.

Question C130 further outlines that if an entity's promise to the customer, or its customary business practice, is to provide a defined number of updates, upgrades or enhancements (e.g. a single release each year with all of the accumulated updates, upgrades and enhancements developed since the previous year's release), that would typically suggest the nature of the entity's promise is to transfer a defined number of releases. It is not a stand-ready obligation to transfer any and all updates, upgrades and enhancements (of an undefined type and quantity) during the support period. In those cases, the transfer of each update is generally a performance obligation satisfied at a point in time.

Question F170

Is a combined performance obligation to provide a non-distinct software license and non-distinct unspecified updates, upgrades and enhancements (and/or unspecified software licenses to additional products) satisfied over time?

Interpretive response: It depends. The entity must first identify the nature of the combined performance obligation, which will often be a matter of judgment. The specific facts and circumstances may affect the conclusion reached in this regard.

If the software entity's promise(s) to provide when-and-if available updates, upgrades or enhancements (and/or additional software licenses) is a stand-ready obligation (see Question F160), we believe it will typically conclude that the nature of the combined performance obligation that is comprised of a license (or licenses) and the promise to provide when-and-if available updates, upgrades, enhancements or additional software licenses to new products is, fundamentally, to provide the customer with ongoing access to an evolving (i.e. changing) suite of software products. On that basis, we believe the software entity would typically conclude that the customer simultaneously receives and consumes the benefits from that access during the combined performance obligation period (e.g. the three year co-terminus license and unspecified update period).

The following examples from Topic 606 illustrate the conclusions reached by the Board as to (1) the nature of a combined performance obligation that includes a license to functional IP and unspecified updates and (2) whether that combined performance obligation is satisfied over time.

Excerpt from ASC 606-10

>>> Example 10—Goods and Services Are Not Distinct

>>>> Case C—Combined Item

55-140D An entity grants a customer a three-year term license to anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The entity frequently provides updates that are critical to the continued utility of the software. Without the updates, the customer's ability to benefit from the software would decline significantly during the three-year arrangement.

55-140E The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer), while the customer can benefit from the updates together with the software license transferred at the outset of the contract.

55-140F The entity concludes that its promises to transfer the software license and to provide the updates, when-and-if available, are not separately identifiable (in accordance with paragraph 606-10-25-19(b)) because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The updates significantly modify the functionality of the software (that is, they permit the software to protect the customer from a significant number of additional viruses that the software did not protect against previously) and are integral to maintaining the utility of the software license to the customer. Consequently, the license and updates fulfill a single promise to the customer in the contract (a promise to provide protection from computer viruses for three years). Therefore, in this Example, the entity accounts for the software license and the when-and-if available updates as a single performance obligation. In accordance with paragraph 606-10-25-33, the entity concludes that the nature of the combined good or service it promised to transfer to the customer in this Example is computer virus protection for three years. The entity considers the nature of the combined good or service (that is, to provide anti-virus protection for three years) in determining whether the performance obligation is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and in determining the appropriate method for measuring progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37.

>>> Example 55—License of Intellectual Property

55-364 An entity enters into a contract with a customer to license (for a period of three years) intellectual property related to the design and production processes for a good. The contract also specifies that the customer will obtain any updates to that intellectual property for new designs or production processes that may be developed by the entity. The updates are integral to the customer's ability to derive benefit from the license during the license period because the intellectual property is used in an industry in which technologies change rapidly.

55-365 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer can benefit from (a) the license on its own without the updates and (b) the updates together with the initial license. Although the benefit the customer can derive from the license on its own (that is, without the updates) is limited because the updates are integral to the customer's ability to continue to use the intellectual property in an industry in which technologies change rapidly, the license can be used in a way that generates some economic benefits. Therefore, the criterion in paragraph 606-10-25-19(a) is met for the license and the updates.

55-365A The fact that the benefit the customer can derive from the license on its own (that is, without the updates) is limited (because the updates are integral to the customer's ability to continue to use the license in the rapidly changing technological environment) also is considered in assessing whether the criterion in paragraph 606-10-25-19(b) is met. Because the benefit that the customer could obtain from the license over the three-year term without the updates would be significantly limited, the entity's promises to grant the license and to provide the expected updates are, in effect, inputs that, together fulfill a single promise to deliver a combined item to the customer. That is, the nature of the entity's promise in the contract is to provide ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. The promises within that combined item (that is, to grant the license and to provide when-and-if available updates) are therefore not separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b).

55-366 The nature of the combined good or service that the entity promised to transfer to the customer is ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. Based on this conclusion, the entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to determine the appropriate method for measuring progress toward complete satisfaction of the performance obligation. The entity concludes that because the customer simultaneously receives and consumes the benefits of the entity's performance as it occurs, the performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) and that a time-based input measure of progress is appropriate because the entity expects, on the basis of its relevant history with similar contracts, to expend efforts to develop and transfer updates to the customer on a generally even basis throughout the three-year term.

Question F180

Is a performance obligation to provide implementation services in a software licensing arrangement satisfied over time?

Interpretive response: In general, yes. In many cases, the customer will be eligible to capitalize at least some portion of the costs of the entity's implementation services (e.g. in accordance with Subtopic 350-40 on internal-use software). Consequently, the entity would conclude that those services create or enhance an asset the customer controls as the entity performs (i.e. meet the second over-time criterion in paragraph 606-10-25-27) and, therefore, the performance obligation is satisfied over time.

In other cases, services characterized as part of 'implementation services' are not capitalizable by the customer (e.g. costs of training or data conversion/migration), and therefore do not create or enhance an asset for the customer. In those cases, the services nevertheless are satisfied over time because the customer consumes and receives benefit from the services as they are provided (i.e. meet the first over-time criterion in paragraph 606-10-25-27) on the basis that another service provider would generally not need to reperform the services provided by the entity to date. For example, another service provider would not need to provide training over aspects of the software that the entity already provided, and once data is converted and migrated from the customer's legacy application, that does not need to be converted or migrated a second time (even if there is additional data that has not yet been converted or migrated).

Therefore, in summary, it typically will be the case that the entity will satisfy its performance obligation to provide implementation services over time regardless of whether the customer can capitalize the cost of those services. Therefore, the information needs for customers to do their accounting may differ from those of the entity.

Question F190

Is a performance obligation to provide implementation services in a SaaS arrangement satisfied over time?

Interpretive response: In general, yes. Some common SaaS implementation services will create an asset for the customer. For example, if a SaaS Provider is developing software for the customer – e.g. developing an application program interface (API) connector – those costs will create an asset for the customer in accordance with Subtopic 350-40 on internal-use software if the customer will run that software on its servers or the developed software otherwise meets the criteria in paragraph 985-20-15-5. In those cases, the entity would conclude that its services create or enhance an asset the customer controls as the entity performs (i.e. meet the second over-time criterion in paragraph 606-10-25-27) and, therefore, the performance obligation is satisfied over time.

Other SaaS implementation services will *not* create or enhance an asset controlled by the customer. If services that will not create an asset for the Customer would not need to be reperformed in the hypothetical scenario where another service provider would be engaged if the entity does not complete the services in full (see Example F190.1 below), then the Customer consumes and receives benefit from the services as the entity performs and, therefore, the performance obligation is satisfied over time.

Most common SaaS implementation services will fit into one of the two categories described in the preceding two paragraphs. However, for any service that does not meet one of the first two over-time criteria (e.g. a consulting service provided by the entity to deliver a report on possible efficiencies the customer could gain from using the entity's SaaS), that service may still be satisfied over time if it meets the third over-time criterion – i.e. the entity's performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance to date.

Remember that it is important to distinguish 'set-up activities' from implementation *services* (see Question C220). Set-up activities cannot be a performance obligation and, therefore, are not assessed for over-time or point-in-time satisfaction separate from the performance obligation of which they are a part.

Example F190.1

Distinct implementation services in a SaaS arrangement

ABC Corp. provides a hosted software solution to customers for which customers generally pay a fixed monthly or quarterly fee. Customers are not permitted to take possession of ABC's software. ABC and Customer enter into a contract for Customer to use ABC's SaaS for three years.

As part of the contract, ABC agrees to perform a variety of services before Customer goes live with ABC's SaaS. These services include training Customer's personnel, converting and migrating Customer's data from its current on-premise solution to ABC's hosted environment, and building an interface to permit the hosted application to supply data to Customer's on-premise general ledger system.

ABC has previously concluded that each of the services is a promised service (rather than a set-up activity) and that the services are distinct from the SaaS offering – see Example C280.1.

The following additional facts are relevant.

- The interface will be resident on the Customer's servers such that Customer concludes the interface is an asset. Because the interface will qualify as internal-use software within the scope of Subtopic 350-40, much of the development costs (that will be paid by Customer to ABC) are capitalizable by the customer.
- The training and data conversion/migration services do not create an asset for Customer and, in fact, Subtopic 350-40 requires Customer to expense the related costs as incurred.

ABC concludes that the distinct implementation services are satisfied over time. In the case of the services to develop the general ledger system interface, ABC's performance creates an internal-use software asset for Customer that Customer controls as ABC performs. In the case of the training and data conversion/migration services, Customer consumes and receives benefit from each of those services as ABC performs because another entity would not need to reperform ABC's work if ABC were to discontinue the services at any point – i.e. Customer would not need to be re-trained on aspects of the application for which ABC already provided training and would not need to have another entity re-convert or re-migrate data already converted/migrated by ABC.

ABC further concludes that its separate performance obligation to provide the SaaS offering is satisfied over time on a basis consistent with that in Example F130.1.

Question F200

Is a combined performance obligation to provide a software license and customization services satisfied over time?

Interpretive response: Example 11, Case B, in Topic 606 (included below) illustrates a scenario in which a software license and services to customize that software are not distinct from each other and, therefore, are a single performance obligation to the customer. However, the example does not conclude, or provide discussion about, whether that single performance obligation is satisfied over time or, instead, at the point in time the customized software is transferred to the customer.

A combined performance obligation to provide software customization is recognized over time if either:

— the customer controls an asset that is being created or enhanced by the entity (paragraph 606-10-25-27(b)) – which we believe will frequently be the case (see below); or

— the software entity's performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance completed to date (paragraph 606-10-25-27(c)).

The customer controls an asset that is being created or enhanced by the entity

We believe that in most cases similar to that in Example 11, Case B, the costs to customize the licensed software (or at least a significant portion of those costs) will be eligible for capitalization as an asset by the customer. For example, if the costs relate to the modification of software for internal-use (e.g. custom modifications to an ERP system or to a platform the entity will use to provide SaaS or process customer transactions), those costs (or a significant portion thereof) would generally be eligible for capitalization in accordance with Subtopic 350-40. In that case, the entity's efforts create and then enhance an asset the customer controls as the entity performs. Importantly, application of this view is not predicated on the software entity knowing the customer's accounting conclusions; rather, the entity evaluates the relevant guidance independently (i.e. based on its own knowledge of the licenses it is transferring and services it is providing).

There is also an alternative view that also results in an 'over-time' revenue recognition conclusion. Under that view, if the customer obtains control of a license to the software before the entity begins to modify that license – e.g. the entity provides the customer with a copy of the pre-modified software and the customer is able to use and benefit from the software before the customization services are provided – then the entity's customizations or modifications enhance that asset the customer controls.

Under either of these views, the combined software license and customization services performance obligation is satisfied over time because the nature of the obligation is the customization of an asset the customer controls as it is being created or enhanced by the entity.

No asset with alternative use and an enforceable right to payment for performance to date

The considerations about whether a software entity has an enforceable right to payment for performance to date are not substantively different from those that apply in other, non-software specific scenarios. Consequently, a software entity's evaluation of these items would generally include the same considerations outlined in the summary to this section applicable to all entities.

However, the considerations around 'alternative use' in a combined software license and customization services scenario present more challenges in interpretation. This is because the guidance (including the Basis for Conclusions to ASU 2014-09) was not written in the context of an asset like software that can be developed and licensed to many customers concurrently. Some stakeholders have expressed that it is unclear whether the asset to be evaluated for alternative use is the asset the customer will obtain (i.e. the software license) or the asset the entity controls (i.e. the software IP).

We believe that, regardless of whether the asset is the license or the software, the principal factor that will affect whether the asset has an alternative use to the entity is the degree to which the customization of the software is *customer-specific* in its completed state (i.e. when the customizations are complete). Regardless of whether one views the asset as the license or the software, if the customizations are specifically tailored to the customer's needs such that they could not be deployed to another customer without substantial changes being made, then neither the license, nor the software customizations made (i.e. the modified or additional code written), have an alternative use to the software entity.

In addition, even customizations that could be redirected to another entity (or for internal-use) would not have an alternative use if there is a substantive contractual restriction on the entity's ability to license the customizations to another party or make use of them itself. Such a scenario might occur when the customer wants to preclude the entity from licensing or selling the customizations to the customer's competitor – e.g. if they believe the customizations provide them with a competitive advantage.

Example F200.1

Combined software license and customization services performance obligation

ABC Corp. licenses trust asset management system software called Product B. The Product B software enables users, typically large financial institutions, to access and value individual US dollar denominated trust account portfolios on a real-time basis. Product B functions as designed without any customization or modification services and can be implemented without ABC's assistance in most cases.

ABC entered into a specific contract with Customer, a large bank, to grant a license to the Product B software and to provide services to modify the customer's instance of the software. This includes modification of the software code and configuration of certain modified and off-the-shelf settings to allow

Customer to access and value its trust account portfolios in multiple foreign currencies in addition to US dollars. ABC expects that it will take approximately 18 months to perform the services.

ABC provides Customer with a master copy of the software at contract inception, and Customer has the right to begin to use the software in its off-the-shelf form immediately if it wanted to do so under the terms of the license, even though ABC expects Customer to 'go live' with Product B only after it has been customized and configured to meet Customer's needs.

In addition:

— ABC's software is internal-use software to Customer.

— While most of the customizations ABC will make to Product B for Customer could be marketed to other similar banks, in its completed state, the customized version of the Product B software includes some highly customer-specific requests in terms of coding and configuration.

— While the contract does not include explicit termination provisions, relevant legal precedent in the jurisdiction governing the contract suggests Customer would be able to terminate the contract under certain circumstances in return for payment in full of ABC's costs incurred to date plus a reasonable return on ABC's capital expended.

In Example C230.1, ABC concludes that the software license and the customization services are a single, combined performance obligation to the customer.

In this example, ABC concludes that the combined performance obligation is satisfied over time. ABC could reach this conclusion on the basis of any one of the following three analyses.

Analysis 1

ABC concludes that it satisfies the combined performance obligation over time in accordance with the second over-time criterion in paragraph 606-10-25-27(b). ABC concludes that as it performs the customization services it is creating an asset for Customer. The resulting customized software will be used by Customer for internal use; therefore, application development stage costs (e.g. coding and testing of the software) will be capitalized by Customer in accordance with Subtopic 350-40 as they are incurred. Consequently, ABC's performance in satisfying the combined performance obligation creates an asset for Customer that Customer controls as it is being created/enhanced.

Analysis 2

ABC concludes that it satisfies the combined performance obligation over time in accordance with the second over-time criterion in paragraph 606-10-25-27(b). This is because Customer obtains control of a license to Product B (i.e. Customer obtains a copy of Product B in its off-the-shelf form and could, if it chose to do so, begin to use and benefit from the software immediately) before ABC enhances that license through the agreed customizations, which significantly increase the utility of the software to which Customer has rights under the license.

Analysis 3

ABC concludes that it satisfies the combined performance obligation over time based on meeting the third over-time criterion in paragraph 606-10-25-27(c). Due to the specialized requests of Customer, the customized software, in its completed state (i.e. when all of the customizations are completed and the software is made available to Customer), does not have an alternative use to ABC – i.e. ABC could not market the customized version of Product B to another customer without substantive changes – and ABC has an enforceable right to payment in the event Customer were to terminate the contract before completing the performance obligation.

Question F201

Does an entity have an enforceable right to payment if the contract does not explicitly state the entity's right to payment upon contract termination?

Interpretive response: Generally, no. We believe that when a contract's written terms do not specify the entity's right to payment upon contract termination, an enforceable right to payment is presumed not to exist. This is consistent with the FASB staff views discussed at the June 26, 2018 Private Company Council meeting.

We believe this presumption (that an enforceable right to payment does not exist) also applies to non-cancellable contracts when there are no written terms to specify the entity's right to payment if the customer breaches the contract.

However, if the entity asserts that it has an enforceable right to payment for performance completed to date in these circumstances, to overcome this presumption, we would expect an entity to do the following.

- Support its assertion (that it has an enforceable right to payment) based on legislation, administrative practice or legal precedent that confers upon the entity a right to payment for performance completed to date. This analysis should demonstrate that an enforceable right to payment exists in the relevant jurisdiction.
- Assess whether relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect.

The fact that the entity may have a basis for making a claim against the counterparty in a court of law would not on its own be sufficient to support that there is an enforceable right to payment as discussed in Question F202.

Question F202

Does the entity's ability and intent to sue if the customer terminates the contract indicate that it has an enforceable right to payment?

Interpretive response: Not necessarily. The key evaluation is whether an entity has an enforceable right to payment. When a right to payment on termination is not specified in the contract with the customer, an entity may presume that the enforceable right does not exist (see Question F201). When evaluating whether an entity may still have a right to payment or whether a stated right is enforceable, an entity considers the relevant laws or regulations.

The fact that the entity may sue a customer who defaults or cancels a contract for convenience does not in itself demonstrate that the entity has an enforceable right to payment. However, in some circumstances an entity might need to go to court to enforce its existing right to payment.

Factors to consider when determining if an entity has a right to payment include:

- relevant laws and regulations – laws and regulations can confer a right to payment even though such a right is not specified in a contract;
- customary business practices – an entity's intent not to enforce a right to payment provision typically does not negate the existence of the right; however, a customary practice of not enforcing similar rights may indicate that the right is not enforceable under the law in the appropriate legal jurisdiction;
- the legal environment;
- relevant legal precedents – legal precedent could indicate whether a right to payment clause in a contract has binding legal effect; and
- legal opinions on the enforceability of rights (see Question F203).

Each individual factor may not be determinative on its own. An entity needs to determine which factors are relevant for its specific set of circumstances. In cases of uncertainty – e.g. when the above factors are inconclusive or provide contradictory evidence about the existence of a right to payment – an entity considers all relevant factors and applies judgment in reaching its conclusion.

Question F203

Does an entity need to obtain a legal opinion to assess whether it has an enforceable right to payment?

Interpretive response: An entity may have an apparent right to payment described in its contract with the customer or under a relevant law or regulation, but there may be uncertainty over whether the right is enforceable. This may be the case when there is no legal precedent for the enforceability of the entity's right.

For example, in a rising property market an entity may choose not to enforce its right to payment in the event of customer default because it prefers to recover the property and resell it at a higher price. A practice of not enforcing an apparent right to payment may result in uncertainty over whether the contractual right remains enforceable.

In such cases, an entity may need a legal opinion to help it assess whether it has an enforceable right to payment. However, all facts and circumstances need to be considered in assessing how much weight (if any) to place on the legal opinion. This may include an assessment of:

— the quality of the opinion – i.e. strength of the supporting legal arguments;
— whether there are conflicting opinions provided by different legal experts; and
— whether there are conflicting legal precedents for similar cases.

Question F204

Can an enforceable right to payment exist for a contract priced at a loss when an entity is not entitled to cost plus a margin for performance completed to date?

Interpretive response: Yes. We believe an entity can have an enforceable right to payment for performance completed when, at contract inception, the contract is priced at a loss.

In assessing whether an enforceable right to payment exists, the entity considers whether it would be entitled to an amount that at least compensates the entity for its performance completed to date in the event of contract termination. This includes an amount that approximates the selling price of the goods or services transferred to date – e.g. recovery of the costs incurred plus a reasonable profit margin.

If the entity is entitled to a proportional amount of the contract price in a contract priced at a loss, we believe that proportional amount would approximate the selling price of the goods or services transferred to date even if that amount is less than costs incurred to date because it is a proportion of the expected price in the contract. We believe the guidance in paragraph 606-10-55-11 that states "for example, recovery of the costs incurred … plus a reasonable profit margin" does not preclude a loss contract from having an enforceable right to payment. That is, a 'reasonable profit margin' could be the loss margin intended at contract inception.

Further, the basis for conclusions to ASU 2014-09 (BC142) describes the right to payment criterion as providing economic protection to the entity from the risk of customer termination, which we believe is achieved if the customer is required to pay the relative proportion of the contract price for performance completed to date in the event of contract termination.

Question F210

How do customer acceptance provisions affect whether a performance obligation is satisfied over time?

Interpretive response: Customer acceptance *may* alter the conclusion that otherwise would have been reached as to whether a performance obligation is satisfied over time. The following table highlights a number of customer-acceptance related scenarios and their effect on whether a performance obligation is satisfied over time.

	If …	Then …	For example …
1	There is substantive uncertainty about whether the entity will meet the customer acceptance provisions	Customer acceptance provisions will preclude recognizing revenue over time	The customer acceptance clause is based on meeting customer-specific criteria and the entity does not have relevant history of meeting substantially similar criteria
2	There are substantive customer-acceptance provisions related to work-in-process in the event of customer termination	Customer acceptance may mean that a right to payment for performance completed to date is not enforceable (i.e. because the customer might not accept the work-in-process)	The customer wants to ensure that if the contract is terminated before completion, it can make use of the work-in-process
3	The entity has significant experience meeting similar acceptance provisions	Customer acceptance generally will not affect whether the performance obligation is satisfied over time	The entity's standard contracts include customer acceptance provisions even when the services are relatively non-complex and/or standard to the entity's arrangements

Comparison to legacy US GAAP

The customer acceptance provisions in Topic 606 are generally consistent with legacy US GAAP. A software entity's considerations under Topic 606 in determining whether it can objectively determine that a good or service meets the agreed-upon specifications in the contract should not differ in any significant manner from that entity's considerations when applying the legacy US GAAP software guidance (paragraphs 985-605-55-80 and 55-81) and SEC guidance (SEC SAB Topic 13).

Question F212

How does a software entity account for additional fees identified through an audit of customer usage?

Interpretive response: It depends. Software licenses often have contractual provisions entitling the licensor to audit a customer's use of the IP to identify usage that is beyond the scope of what is allowed in the contract or to ensure the customer is properly reporting its royalty payments.

The primary issue is the timing of when the fees from the audit should be recorded. This includes audits after the balance sheet date but before the financial statements are issued (available to be issued), which means that the guidance in Topic 855 (subsequent events) is relevant.

To determine the appropriate accounting, the entity starts by determining whether the additional usage is an additional license or a sales- or usage-based royalty subject to the royalty exception (see Question C390).

Additional license

The original license agreement may include options for the customer to purchase additional user licenses on the same terms and conditions as the original license. In that case, the customer obtains control of the additional user licenses through exercise of its contractual option, and the entity will be entitled to additional consideration. If the customer does not issue a purchase order or notify the entity, it does not change the entity's enforceable rights to the consideration.

In contrast, if the original license does not include options, the entity may not have an enforceable right when the unauthorized usage occurs.

Original license includes options

If an audit has *not* occurred, we believe an entity generally should not record an estimate of additional unknown licenses at the end of each period unless there is:

— an established history of customers with contractual options adding user licenses and not communicating those additions timely; or
— information about a particular customer that provides the entity with the ability to estimate.

This approach is consistent with the additional consideration being variable consideration, similar to an unpriced change or contract claim (see *Chapter G – Contract modifications*). In considering the variable consideration guidance (including the constraint), absent the history or specific customer information, the estimate would generally be zero. In contrast, when a history or specific information exists, that information provides a basis for the entity to include an amount in the transaction price when considering the variable consideration guidance (including the constraint).

When the entity performs an audit after the balance sheet date but before the financial statements are issued (available to be issued), it needs to consider whether the audit gives rise to a recognized or unrecognized subsequent event under Topic 855. For a more detailed discussion of subsequent events, see chapter 9 of KPMG Handbook, Financial statement presentation.

When the original agreement includes options, and the rights are enforceable at the balance sheet date, we believe the audit should be considered a recognized subsequent event, and the additional fees recognized in the period of usage of the license. This is because the audit confirms the condition that existed at the balance sheet date – i.e. the enforceable right to the consideration.

Original license does not include options

When the original contract does not provide the right to acquire additional licenses or specific monetary remedies for unauthorized use, the entity needs to evaluate whether enforceable rights and obligations exist when the contract does not specifically address this use. In performing this evaluation, we believe entities should consider Question B60, which discusses a continuation of service after a contract has expired.

In a scenario with unauthorized use, we believe that a customer generally will need to agree to a new contract after the audit is concluded for revenue to be recognized, because the nature of the transaction calls into question whether the contract existence criteria are met (see *Chapter B – Step 1: Identify the contract with the customer*). Specifically, there is uncertainty about the customer's commitment to its contractual obligations and the collectibility of any license fees not paid upfront. Therefore, no revenue is recognized until that event occurs.

Similarly, if a contract does not exist at the balance sheet date, the contract entered into after the balance sheet date but before the financial statements are issued (available for issuance) is a nonrecognized subsequent event. This is because the new contract represents new facts and circumstances; it does not confirm a condition that existed at the balance sheet date.

Sales- or usage-based royalty

As discussed in Question F350, if the consideration to which the entity is entitled from a sales- or usage-based royalty is not known in time for an entity's financial reporting, the entity estimates the royalties to which it is entitled using the model for estimating variable consideration. When the additional usage is subject to the royalty exception, the results of the audit will likely cause an entity to adjust its estimate of the royalties earned.

If the audit occurs after the balance sheet date but before the financial statements are issued (available for issuance), the entity considers Topic 855 to evaluate whether information gained from an audit results in a recognized or nonrecognized subsequent event. Generally, when the audit confirms usage that occurred before the end of the reporting period, the audit is considered a recognized event. This is because it confirms a condition or estimate that existed on the balance sheet date – i.e. the estimated amount of usage that already occurred.

Example F212.1
User license audits

On January 1, Year 1, Software Co entered into a license agreement with Customer. The agreement gives Customer the right for 500 users to use Software Co's proprietary software at a price of $100 per user.

Under the license agreement, Customer may purchase additional user licenses, subject to the same terms and conditions as the original user licenses, for $100 per user. Without purchasing additional user licenses, usage of the software by more than 500 users is prohibited and is considered noncompliance with the contract (and potentially piracy).

Each user represents a separate license. Because the price per additional user license equals the price of the original user licenses, the option to acquire additional user licenses does not provide Customer with a material right.

Software Co has contractual audit rights related to Customer's use of its software.

The dates in the following scenarios are all in Year 1.

Scenario 1: Audit is a recognized subsequent event

On June 1, Customer allows 100 additional users to begin using the software (i.e. there are now a total of 600 users), but does not communicate this to Software Co. On July 15, Software Co performs a license audit and identifies the additional users. On August 15, Customer issues a purchase order for $10,000 for the amount owed for the additional user licenses.

In this scenario, Customer obtained control of the 100 additional user licenses on June 1. At that date, Customer has already obtained (1) a copy of the software and (2) the ability to use and benefit from those additional user licenses. Customer also had a contractual right to obtain the licenses.

Software Co prepares financial statements for the period ending June 30 that are issued on July 30. The audit on July 15, occurs before the financial statements are issued (available for issuance). The audit provides information about a recognized subsequent event because Customer obtained control of the 100 additional user licenses on June 1 through exercise of its contractual option.

Therefore, the revenue for the 100 additional user licenses is recognized in Software Co's June 30 financial statements. As a next step, Software Co needs to consider whether there is a history of concessions that may indicate the additional fee is variable and consider the guidance on variable consideration.

Scenario 2: Audit is an unrecognized subsequent event

Assume the same facts as Scenario 1, except that Software Co does not undertake license audits regularly and does not audit Customer before the June 30 financial statements are issued (made available for issuance).

Further, historically Software Co's customers do not add user licenses without communicating their take-down of such licenses timely. Software Co’s license audits rarely uncover significant unreported license usage.

Software Co considers the variable consideration guidance and does not recognize estimated additional license revenue in its June 30 financial statements. This decision is based on the following reasons.

- No subsequent event has occurred – i.e. no license audit occurs before the financial statements are issued (made available for issuance).
- Software Co's lack of history of additional licenses not being communicated, or specific information suggesting an issue with this contract, indicates that the amount of additional license revenue for unreported licenses to which Software is entitled through the second quarter of Year 1 is $0.

If Software Co had different historical information, or contract-specific information that pointed to additional licenses, it would likely be appropriate for Software to estimate (subject to the constraint) the revenue to which it expects to be entitled for the user licenses Customer added, but did not communicate, as of June 30.

Scenario 3: Additional users not allowed under original contract

Assume the same basic facts as Scenario 1, except that the license agreement does not allow Customer to obtain additional users. Therefore, use of the software by more than 500 Customer users is a violation of the agreement. To increase its user licenses, Customer must enter into a new contract with Software Co.

On June 1, Customer violates the agreement by providing 100 additional users (making 600 users in total) access to Software Co's software. On July 15, Software performs a license audit and identifies the additional users.

On August 15, Customer and Software Co reach an agreement under which Customer will pay for the additional 100 user licenses. Accordingly, Customer issues a purchase order for $10,000 and Software Co formally grants 100 additional user licenses.

Software Co concludes that no contract exists until the additional license amendment is agreed on August 15. This is because it lacks evidence that Customer is committed to its obligations or that Software will grant Customer the license until the final terms are agreed. Therefore, Software does not recognize revenue until that date. The audit does not confirm an event that existed at the balance sheet date – the contract for the additional user licenses did not yet exist.

Question F216

How does a software entity recognize fees associated with a settlement with a non-customer who used the entity's software without obtaining a license?

Background: A software entity may identify instances in which non-customers are using its software without first obtaining a valid license. In these instances, the software entity may subsequently enter into a contractual arrangement with the non-customers thereby granting them a license for future use while also incorporating compensation for the past use of the software into the overall fee. For example, the parties enter into a three-year license at beginning of Year 2 that retroactively covers Year 1 and continues through the end of Year 3.

Question B60 provides guidance for different situations where the entity continues to provide services after a contract expired to a customer that previously obtained a license for software (i.e. for situations when the previous use is authorized).

Interpretive response: The accounting for this type of contract will include considering:

— **Contract existence** – When an unauthorized user has not previously been a customer, we believe the considerations about contract existence are generally consistent with those in other new customer scenarios. However, the new customer's previous unauthorized use (i.e. infringement) of the entity's software may suggest there is uncertainty about the customer's commitment to its contractual obligations (ASC 606-10-25-1(a)) and the collectibility of license fees not paid upfront (ASC 606-10-25-1(e)).

— **Settlement amounts** – Consistent with Question A60, the license fee (including amounts attributable to 'past due license fees') should be distinguished from a 'settlement payment' agreed to by the third party to incent the software entity to forgo some or all of its legal rights or remedies for the past infringement. A 'settlement payment' excluded from the revenue contract is recognized at the point at which the vendor becomes entitled to it (realized or realizable – i.e. final settlement reached) in accordance with ASC 450-30 (gain contingencies). See Question A60 for discussion on identifying a settlement payment.

Once the software entity has allocated consideration to the settlement amount and the license fees, the amount allocated to the license fee is accounted for under Topic 606. When the license is distinct from other goods or services, fees allocated to the license would be recognized at the point in time the customer obtains control of the license which would be the date the contract is entered into because the customer has (1) a copy of the software and (2) the right to use and benefit from the software.

When the contract has performance obligations satisfied over time in addition to a distinct license (e.g. PCS) or only has a single performance obligation satisfied over time, we believe the software entity should generally recognize the entire fee allocated to the over-time performance obligation over the remaining service period (i.e. prospectively). This would be the case regardless of whether the contract indicated the fees were for previous periods because the software entity did not 'perform' during the earlier year(s) of the arrangement – i.e. it had neither granted the license, nor was it standing ready to provide the customer (then an unauthorized user of the software) with PCS.

There may be limited instances in which a cumulative effect approach may also be appropriate. For example, when the license and integral updates (see Question C170) are combined into a single over-time performance obligation and the customer has consumed and received the benefit of that combined performance obligation before entering into the contract, a cumulative effect approach may be appropriate.

Measuring progress toward complete satisfaction of a performance obligation satisfied over time

Excerpt from ASC 606-10

>> Measuring Progress toward Complete Satisfaction of a Performance Obligation

25-31 For each **performance obligation** satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity shall recognize **revenue** over time by measuring the progress toward complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a **customer** (that is, the satisfaction of an entity's performance obligation).

25-32 An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress toward complete satisfaction of a performance obligation satisfied over time.

>>> Methods for Measuring Progress

25-33 Appropriate methods of measuring progress include output methods and input methods. Paragraphs 606-10-55-16 through 55-21 provide guidance for using output methods and input methods to measure an entity's progress toward complete satisfaction of a performance obligation. In determining the appropriate method for measuring progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer.

25-34 When applying a method for measuring progress, an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.

25-35 As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

>>> Reasonable Measures of Progress

25-36 An entity shall recognize revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress toward complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress.

25-37 In some circumstances (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 the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognize revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

>> Methods for Measuring Progress toward Complete Satisfaction of a Performance Obligation

55-16 Methods that can be used to measure an entity's progress toward complete satisfaction of a **performance obligation** satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29 include the following:

a. Output methods (see paragraphs 606-10-55-17 through 55-19)
b. Input methods (see paragraphs 606-10-55-20 through 55-21).

>>> Output Methods

55-17 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. Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered. When an entity evaluates whether to apply an output method to measure its progress, the entity should consider whether the output selected would faithfully depict the entity's performance toward complete satisfaction of the **performance obligation**. An output method would not provide a faithful depiction of the entity's performance if the output selected would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in process or finished goods controlled by the customer that are not included in the measurement of the output.

55-18 As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.

55-19 The disadvantages of output methods are that the outputs used to measure progress may not be directly observable and the information required to apply them may not be available to an entity without undue cost. Therefore, an input method may be necessary.

>>> Input Methods

55-20 Input methods recognize **revenue** on the basis of the entity's efforts or inputs to the satisfaction of a **performance obligation** (for example, resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis.

55-21 A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a **customer**. Therefore, an entity should exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 606-10-25-31, do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

a. When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognize revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labor, or other resources that were incurred to satisfy the performance obligation).
b. When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:
    1. The good is not distinct.
    2. The customer is expected to obtain control of the good significantly before receiving services related to the good.
    3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.
    4. The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs 606-10-55-36 through 55-40).

For each performance obligation that is satisfied over time, an entity applies a *single* method of measuring progress toward complete satisfaction of the obligation. The objective is to depict the transfer of control of the goods or services to the customer. To do this, an entity selects an appropriate output or input method. It then applies that method consistently to similar performance obligations and in similar circumstances.

Method	Description	Examples
Output	Based on direct measurements of the value to the customer of goods or services transferred to date, relative to the remaining goods or services	— Surveys of performance to date — Appraisals of results achieved — Milestones reached

Method	Description	Examples
	that are part of the performance obligation	— Time elapsed
Input	Based on an entity's efforts or inputs toward satisfying a performance obligation, relative to the total expected inputs to the satisfaction of that performance obligation	— Resources consumed — Costs incurred — Time-based — Labor hours expended — Machine hours used

Topic 606 requires an entity to select a method that is consistent with the objective of depicting its performance. An entity therefore does not have a free choice of which method to apply to a given performance obligation – it needs to consider the nature of the good or service that it promised to transfer to the customer. While the standard requires an entity to update its estimates related to the measure of progress selected, it does not allow for a change in methods. A performance obligation is accounted for under the method selected (input or output method) until the performance obligation has been fully satisfied. Further, the standard requires that the selected method be applied to similar contracts in similar circumstances.

When evaluating which method of measuring progress depicts the transfer of control of a good or service, the entity's ability to apply that method reliably may also be relevant. For example, the information required to use an output method may not be directly observable or may require undue cost to obtain – in these circumstances, an input method may be appropriate.

Considerations for output methods

An output method may not provide a faithful depiction of performance if the output method selected fails to measure some of the goods or services for which control has transferred to the customer.

For example, if at the reporting date an entity's performance has produced work in progress or finished goods that are controlled by the customer, then using an output method based on units produced or units delivered as it has been applied historically would distort the entity's performance. This is because it would not recognize revenue for the assets that are created before delivery or before production is complete but that are controlled by the customer.
[ASU 2014-09.BC165]

If control transfers to the customer over time, then the measure of progress should reflect this. Therefore, although Topic 606 lists milestones achieved as an example of a possible measure of progress when using an output method, it remains necessary to consider whether the milestones faithfully depict performance, particularly if the milestones are widely spaced. This is because the premise underlying satisfaction of a performance obligation over time is that control generally transfers continuously as the entity performs rather than at discrete points in time. As a result, a milestone method would typically need to incorporate a measure of progress between milestone achievements to faithfully depict an entity's performance.

Combined performance obligations

Selecting a single measure of progress may be difficult when a single performance obligation contains multiple promised goods or services that will be transferred over different periods of time. For example, this might occur when a performance obligation combines a software license or SaaS and professional services, or a software license and a SaaS element or a right to unspecified updates, upgrades or enhancements. Significant judgment may be required in some circumstances, and understanding the nature of the entity's overall promise to the customer is key for the entity to select a reasonable measure of progress in these circumstances.

Significant difficulty selecting a single measure of progress may suggest the entity should reconsider its assessment of the performance obligations – i.e. the entity should consider whether there are multiple performance obligations rather than a single performance obligation. Nevertheless, just because the identification of a single measure of progress is challenging does not necessarily mean by itself that the promised goods or services are not a single performance obligation.

Time-based measures of progress

Use of a time-elapsed output measure of progress or a time-based input measure of progress will generally result in a straight-line attribution of revenue (e.g. a time-elapsed or time-based measure of progress would result in straight-line recognition of the revenue attributable to a three-year SaaS performance obligation) – i.e. excluding the potential effects of variable consideration that may mean equal revenue is not recognized each period for a performance obligation satisfied over time.

A time-elapsed output measure of progress is appropriate when direct measurements of the value to the customer evidence that the customer obtains generally equal benefit from the service (including SaaS) throughout the service period.

A time-based input measure of progress is appropriate when the entity's inputs (e.g. costs or efforts) are incurred evenly over time. This may be the case, for example, when the entity's costs to provide a service (e.g. technical support in a software licensing arrangement or access to a hosted software application or platform) are fixed and not dependent on how much the customer uses the service (e.g. how many support calls the customer makes or how much the customer makes use of the hosted software).

Stand-ready obligations

Judgment is required to determine an appropriate measure of progress for a stand-ready obligation. A time-based measure of progress will frequently be appropriate for recognizing revenue for a stand-ready obligation, including a performance obligation to provide when-and-if available software updates, upgrades and enhancements. However, that will not always be the case. The TRG, at its January 2015 meeting, discussed an example of an annual contract to provide snow removal services in an area where snowfall is seasonal, concluding that a straight-line basis of recognition would not be appropriate because the pattern of benefit of these services, as well as the entity's effort to fulfill the performance obligation, would not generally be even throughout the year because snow is only expected in the late fall/winter. That is, the revenue attributable to this performance obligation would likely be recognized entirely (or almost entirely) during the November through March period of the annual contract when the service provider has equipment and crews on standby to address snowfall. Question F220 describes the circumstances in which it would generally not be appropriate to use a time-based measure of progress for a performance obligation to provide technical support services or when-and-if available software updates, upgrades and enhancements.

When making the judgment, an entity considers the substance of the stand-ready obligation to ensure that the measure of progress aligns with the nature of the underlying promise. In assessing the nature of the obligation, the entity considers all relevant facts and circumstances, including the timing of transfer of goods or services, and whether the entity's efforts (i.e. costs) are expended evenly throughout the period covered by the stand-ready obligation.

'As-invoiced' practical expedient

As a practical expedient, if an entity has a right to invoice a customer at an amount that corresponds directly with the value to the customer of the entity's performance to date, then it can recognize revenue at that amount. For example, in a services contract an entity may have the right to bill a fixed amount for each unit of service provided. [606-10-55-18]

This practical expedient is an expedient to parts of Step 3, 4 and 5 of the Topic 606 revenue model. Revenue is recognized on the basis of invoicing and revenue is recognized based on the price multiplied by the measure of progress (quantities or units transferred). An entity that uses this practical expedient bypasses determining a transaction price (Step 3), allocating the transaction price to performance obligations (Step 4) and determining when to recognize revenue (Step 5).

The determination of whether the invoice amount represents equivalent value to the customer may be more difficult in scenarios with multiple performance obligations or where the fixed amount per unit changes over time. This might occur with contracts that have declining unit prices, rates with forward market curves, rates with contractual minimums or contracts with volume rebates. In these cases, judgment is required to determine whether the changes in pricing are in response to a change in the underlying value to the customer.

If a contract includes fixed fees in addition to per-unit invoicing (whether paid upfront or over time), substantive contractual minimums or payments to the customer such as rebates, discounts or signing bonuses, then the use of the practical expedient may be precluded because they cause the invoiced amounts not to correspond to the value that the customer receives.

Observation

Topic 606 provides another pathway – i.e. other than the 'as-invoiced' practical expedient – in accordance with which entities such as SaaS providers may not be required to estimate transaction-based fees (at least not for the entire contract period). *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract* discusses the circumstances in which an entity can allocate variable consideration within a performance obligation to distinct goods or services that comprise the performance obligation (e.g. a series of distinct months or quarters within a three-year SaaS arrangement).

We believe this guidance will generally provide a more viable pathway in more circumstances for entities to recognize revenue resulting from usage- or transaction-based fees (and similar) in the distinct service periods in which the usage or transactions occur.

Adjusting the measure of progress

An entity applying an input method excludes the effects of any inputs that do not depict its performance in transferring control of goods or services to the customer. In particular, when using a cost-based input method – e.g. cost-to-cost – an adjustment to the measure of progress may be required when an incurred cost:

— does not contribute to an entity's progress in satisfying the performance obligation – e.g. unexpected amounts of wasted materials, labor issues (e.g. initially assigning personnel to a task or activity that were not correct for that task or activity) or other resources (these costs are expensed as they are incurred); or

— is not proportionate to the entity's progress in satisfying the performance obligation – e.g. uninstalled materials.

Generally, some level of inefficiency, rework or overrun is assumed in a professional service or construction contract and an entity contemplates these in the arrangement fee. Although Topic 606 specifies that unexpected amounts of wasted materials, labor or other resources should be excluded from a cost-to-cost measure of progress, it does not provide additional guidance on how to identify unexpected costs. Judgment is therefore required to distinguish normal wasted materials or inefficiencies from those that do not depict progress toward completion. [ASU 2014-09.BC176–BC178]

Reasonable measure of progress

An entity may not be able to measure its progress if reliable information required to apply an appropriate method of measuring progress is not available. However, if the entity cannot reasonably measure the outcome, but expects to recover the costs incurred in satisfying the performance obligation, then it recognizes revenue to the extent of the costs incurred (i.e. a 'zero-margin' recognition method).

Comparison to legacy US GAAP

Input vs output measures

Legacy US GAAP (other than that applicable to construction-type and production-type contracts) indicated that if a reliable measure of output could be established, then it was generally the best measure of progress toward completion; however, it acknowledged that output measures often cannot be established, in which case input measures are used.

The Basis for Conclusions to ASU 2014-09 states the Boards' view that an output measure is, conceptually, the most faithful depiction of an entity's performance because it directly measures the value of the goods or services transferred to the customer; however, Topic 606 does not require an output measure be used, even if available, if an input method would also provide a reasonable basis for measuring progress and it would be less costly to apply.

In general, we do not expect software entities will have to apply substantially different measures of progress to their performance obligations than they did to their elements under legacy US GAAP. For example, a software entity that measured progress toward completion of its professional services or a software customization project using a cost-to-cost or labor hours input method under legacy US GAAP is likely able to continue that practice under Topic 606 in most cases – assuming that the over-time criteria are met.

Revenue vs margin

Under legacy US GAAP for construction-type and production-type contracts, the percentage-of-completion method was used to determine the amount of revenue *and costs* to recognize, and there were two methods acceptable for this determination.

— Alternative A provided a basis for recognizing costs in the financial statements earlier or later than when they are incurred.
— Alternative B allowed an entity to apply a margin to the costs incurred.

Topic 606 supersedes both of these methods. Topic 606 and Subtopic 340-40, in general, separate the recognition of revenue from the recognition of contract costs – i.e. while the legacy US GAAP construction-type and production-type contract guidance was focused on margin, Topic 606 is not. However, if an entity uses cost-to-cost as its measure of progress, then the amount of revenue and costs recognized will be similar to the amounts recognized under Alternative B in the legacy construction-type and production-type contract guidance. Additionally, the margin expressed as a percentage of revenue will generally remain constant throughout the contract. [605-35-25-70 – 25-81, 25-83 – 25-84, ASU 2014-09.BC164]

Zero-margin recognition

If estimating the final outcome was impracticable, except to assure that no loss would be incurred, then legacy US GAAP for construction-type and production-type contracts recommended use of the percentage-of-completion method based on a zero percent profit margin (rather than the completed-contract method) until more precise estimates can be made. This scenario may arise if the scope of the contract is ill-defined but the contractor is protected by a cost-plus contract or other contractual terms.

This is consistent with the requirement in Topic 606 that revenue should be recognized only to the extent of costs incurred – i.e. at a zero percent profit margin – when the entity cannot reasonably measure its progress, but expects to recover its costs to satisfy the performance obligation. However, Topic 606 and Subtopic 340-40 do not include guidance on the accounting for losses, and therefore the existing guidance on onerous contracts remains applicable. [605-35-25-60, 25-66 – 25-67]

A zero gross margin approach was applied in some software-specific circumstances not contemplated by the guidance in legacy Subtopic 605-35 (e.g. when a contract includes services essential to the software's functionality and PCS or hosting services for which the entity did not have vendor-specific objective evidence of fair value). Question F270 discusses measures of progress for similar performance obligations – i.e. those that may combine professional services and a right to receive unspecified updates, upgrades and enhancements – under Topic 606.

Completed contract method

Under legacy US GAAP, an entity used the completed contract method when it could not make reasonably dependable estimates for construction- and production-type contracts in the scope of Subtopic 605-35. Under the completed contract method, the entity deferred revenue and costs until the contract was complete or substantially complete, other than to the extent it was required to accrue an expected loss. [605-35-25-88 – 25-91]

The completed contract method as it existed under legacy US GAAP is not permitted under Topic 606. Even though an entity may conclude, in infrequent circumstances, that for some period of time after performance begins that it cannot recognize revenue over time because it lacks reliable information that would be required to apply an appropriate measure of progress, the entity would not also defer contract costs as it does currently under the completed contract method. The entity would expense its contract costs as incurred. That the entity in that scenario cannot reliably measure progress toward satisfaction of the performance obligation does not change the fact that the work in progress is transferring continuously to the customer when one or more of the over-time criteria are met.

There is no mechanism for deferral of contract costs under Topic 606 (or Subtopic 340-40) for performance obligations satisfied over time, such as occurs under the completed contract method in legacy US GAAP.

Question F220

When is it not appropriate to recognize revenue for a technical support or unspecified updates/ upgrades/enhancements 'stand-ready obligation' on a straight-line basis?

Interpretive response:

Technical support

If technical support is a stand-ready obligation (see Question F150), a straight-line measure of progress will typically be appropriate.

Unspecified updates, upgrades and enhancements (or rights to use unspecified additional software products)

Question C130 provides relevant considerations about when an obligation to provide unspecified updates, upgrades and enhancements is, or is not, a stand-ready obligation and the circumstances in which a straight-line measure of progress would not be appropriate to apply to such a performance obligation, considerations which apply equally to an obligation to provide rights to use unspecified additional software products. These include:

— if it is expected (based on an explicit promise to the customer or the entity's customary business practice) that releases will always or predominantly occur at a specific time (or in a specified period – e.g. the fourth quarter) each year, an input-based measure, resulting in an other than straight-line revenue attribution and reflective of the uneven efforts that the entity will undertake to transfer the releases to the customer each year of the obligation period, may be appropriate.

— if it is expected at contract inception that there will be a significant upgrade or enhancement (that is not a specified upgrade or enhancement) transferred to the customer at a specific point in time during the support period (e.g. the software entity expects to release principally bug fixes and other minor updates throughout the support period, but also expects to release a significant enhancement or version upgrade 12 months after contract inception that will substantially enhance the licensed software), the benefit the customer will receive from the unspecified update, upgrade or enhancement provision may not be even throughout the obligation period. Therefore, a different measure of progress (i.e. other than one that is time-based) may be more appropriate.

Example F220.1

Time-based measure of progress for technical support services

This is a continuation of Example F150.1.

ABC Corp. and Customer enter into a contract for Customer to license Software Product H and for ABC to provide technical support for the full three-year license period. The terms of the support agreement specify that ABC's helpdesk and web support operators are available from 8-5 each day other than Sundays; while ABC's web page providing support FAQs as other 'helpful hints' is available 24/7.

In Example F150.1, ABC concluded both that:

— the software license and the technical support services are separate performance obligations; and

— the technical support services are a 'stand-ready obligation' satisfied over time on the basis that Customer consumes and receives benefit from having access to ABC's support resources, when and as needed, throughout the three-year support period as ABC performs by maintaining its support infrastructure (e.g. website, helpdesk) and making that available to Customer in accordance with the terms of the support agreement.

ABC further concludes that it will recognize revenue attributable to the technical support obligation on a straight-line basis. A time-based measure of progress is considered appropriate as the entity's efforts to fulfill its stand-ready performance obligation are generally expended evenly throughout the support period – i.e. ABC's principal efforts are those that occur continuously throughout the support period to maintain the availability of the helpdesk, support personnel and website.

Example F220.2

Time-based measure of progress appropriate for unspecified updates, upgrades and enhancements

ABC Corp. and Customer enter into a contract for Customer to license Software Product H and for ABC to provide unspecified updates, upgrades and enhancements for the full three-year license period.

Based on the relevant facts and circumstances, ABC concludes that (i) the software license and (ii) the unspecified update, upgrade and enhancement rights are distinct from each other and, therefore, separate performance obligations (see Question C170).

The distinct software license is satisfied at a point in time (see Question F20).

ABC has a relevant history of providing unspecified items to customers on a regular basis; however, the quantity and the mix (i.e. bug fixes, updates or upgrades/enhancements) of those items a customer will receive and the timing of releases within a given period vary. Therefore, ABC concludes both that:

— the nature of its performance obligation to provide unspecified updates, upgrades and enhancements is a 'stand-ready obligation'; and

— it expects to expend efforts to develop and transfer unspecified items to the customer on a generally even basis throughout the three-year term such that a time-based measure of progress, resulting in straight-line revenue recognition for the performance obligation, is appropriate.

Comparison to legacy US GAAP

Legacy US GAAP on recognizing revenue from specified and unspecified upgrades has been superseded. However, the guidance applicable to these performance obligations under Topic 606 is not expected to result in a significant change in practice with respect to:

— measuring progress for performance obligations to provide when-and-if-available updates, upgrades and enhancements (i.e. assuming it is a stand-ready obligation); and
— identifying specified upgrades as performance obligations.

However, unlike legacy US GAAP, under which the entire arrangement consideration was typically deferred until a specified upgrade was delivered (i.e. because entities typically did not have vendor-specific objective evidence of fair value for those specified upgrades), entities will only allocate a portion of the transaction price to the specified upgrade and will generally recognize revenue for the initial software license when control of that license transfers to the customer.

The accounting for unspecified additional software products has also changed under Topic 606. Under legacy US GAAP, a promise to provide unspecified additional software products resulted in subscription accounting for the entire software arrangement (i.e. because an entity could not establish vendor-specific objective evidence of fair value for licenses to not-yet-developed software products). In contrast, under Topic 606, most such rights will be distinct and therefore the initial software license(s) will be accounted for separately (i.e. as a separate performance obligation) from the unspecified additional software product rights. Distinct unspecified additional software product rights will be subject to the same considerations for determining an appropriate measure of progress as a promise to provide unspecified updates, upgrades and enhancements.

Question F230

What is an appropriate measure of progress for a combined performance obligation that includes a software license and rights to unspecified updates, upgrades and enhancements (and/or rights to use unspecified additional software products)?

Interpretive response: Just as it is vital to determine the nature of the combined performance obligation – i.e. to determine the nature of the *overall* promise to the customer that includes the software license and the unspecified update, upgrade and enhancement rights – when assessing if it is satisfied over time (see Question F170), determining the nature of the combined performance obligation is also vital to assigning an appropriate measure of progress to those that are satisfied over time. The TRG discussed this concept at its July 2015 meeting and the members generally agreed that, in determining the nature of a combined performance obligation, an important consideration may be the reason(s) why the entity decided that the goods or services are not distinct from each other.

We believe that, in most cases, the nature of the entity's overall promise to the customer when the performance obligation includes a software license and unspecified update, upgrade and enhancement rights (and/or rights to use unspecified additional software products) is fundamentally an obligation to provide the customer with ongoing access to the entity's most current IP. This is because the basis for the conclusion that the license and the unspecified item rights are not distinct from each other in these cases is the integral nature of the updates, upgrades, enhancements or additional software licenses to the arrangement – i.e. typically, the basis for any conclusion that a software license and rights to unspecified items are not distinct will be that the utility to the customer of the initially transferred software will degrade *significantly* during the license period if updates, upgrades or enhancements (and/or rights to use additional software products) are not provided.

Consequently, we believe the measure of progress toward satisfaction of the combined performance obligation will typically be driven by what an appropriate measure of progress would be for the promise to provide the unspecified items if it were evaluated on a stand-alone basis. For example, if the promise to provide the unspecified items, if assessed on a stand-alone basis, would be considered a stand-ready obligation satisfied over time (see Question F160) and that a time-based measure of progress would be appropriate for that obligation if it were distinct (see Question F220), it would generally be appropriate to apply the same time-based measure of progress to the combined performance obligation.

While Topic 606 does not provide explicit guidance to this effect, we believe Example 55 (paragraphs 606-10-55-364 – 55-366) supports the position in the preceding paragraph as that example reaches its conclusion about the appropriate measure of progress to apply to the combined performance obligation on the basis of the entity's expected efforts to develop and transfer the updates and upgrades to the customer.

As outlined in Question F220, a time-based measure of progress will not always be appropriate for a promise to provide unspecified updates, upgrades and enhancements (or rights to use unspecified additional software products).

Excerpt from ASC 606-10

>>> Example 55—License of Intellectual Property

55-364 An entity enters into a contract with a customer to license (for a period of three years) intellectual property related to the design and production processes for a good. The contract also specifies that the customer will obtain any updates to that intellectual property for new designs or production processes that may be developed by the entity. The updates are integral to the customer's ability to derive benefit from the license during the license period because the intellectual property is used in an industry in which technologies change rapidly.

55-365 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer can benefit from (a) the license on its own without the updates and (b) the updates together with the initial license. Although the benefit the customer can derive from the license on its own (that is, without the updates) is limited because the updates are integral to the customer's ability to continue to use the intellectual property in an industry in which technologies change rapidly, the license can be used in a way that generates some economic benefits. Therefore, the criterion in paragraph 606-10-25-19(a) is met for the license and the updates.

55-365A The fact that the benefit the customer can derive from the license on its own (that is, without the updates) is limited (because the updates are integral to the customer's ability to continue to use the license in the rapidly changing technological environment) also is considered in assessing whether the criterion in paragraph 606-10-25-19(b) is met. Because the benefit that the customer could obtain from the license over the three-year term without the updates would be significantly limited, the entity's promises to grant the license and to provide the expected updates are, in effect, inputs that, together fulfill a single promise to deliver a combined item to the customer. That is, the nature of the entity's promise in the contract is to provide ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. The promises within that combined item (that is, to grant the license and to provide when-and-if available updates) are therefore not separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b).

55-366 The nature of the combined good or service that the entity promised to transfer to the customer is ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. Based on this conclusion, the entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to determine the appropriate method for measuring progress toward complete satisfaction of the performance obligation. The entity concludes that because the customer simultaneously receives and consumes the benefits of the entity's performance as it occurs, the performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) and that a time-based input measure of progress is appropriate because the entity expects, on the basis of its relevant history with similar contracts, to expend efforts to develop and transfer updates to the customer on a generally even basis throughout the three-year term.

Comparison to legacy US GAAP

Under legacy US GAAP, a software license and PCS were accounted for as a single element if the software entity did not have vendor-specific objective evidence of fair value (VSOE) for the undelivered PCS element. The notion of VSOE no longer exists; therefore, the population of arrangements that will be accounted for as a single, combined performance obligation under Topic 606 will be considerably fewer than, and different from, the population of similar arrangements accounted for as a single element under legacy US GAAP.

That being said, revenue recognition for a single, combined element comprised of a license and PCS under legacy US GAAP and revenue recognition for a combined performance obligation comprised of a license and a right to unspecified items, when that occurs, are likely to be substantially similar. Under legacy US GAAP, revenue for the combined element was recognized ratably over the PCS period.

Similarly, we expect revenue for most combined performance obligations that include a software license and rights to unspecified items will also be recognized ratably over the period to which the customer has the right to unspecified items.

Question F235

When should an entity begin to recognize revenue for a 'stand-ready' service promised to a customer's customer?

Interpretive response: When the end customer has the ability to access and begin to consume and benefit from the service.

This situation could arise when an entity sells a product (including a software license) through a distributor or other intermediary but also promises, explicitly or implicitly, to provide a service to the end customer (i.e. the customer's customer). For example, a software entity may enter into a licensing arrangement with a reseller and also provide an online hosting service to the reseller's end customer. See Question C100 on identifying promises made to a customer's customer.

Careful consideration will need to be given to when control of the promised service begins to transfer to the reseller or the reseller's customer. In the case of an online hosting or streaming service, typically the reseller's customer is the party who will benefit from access to the stand-ready service. And therefore, control of the online hosting or streaming service does not begin to transfer (and the software entity does not begin to recognize revenue for that performance obligation) until the end customer can begin to consume and benefit from the service (which is typically when the end customer obtains the license).

If the entity does not have visibility into the distributor's sales to specific end customers, it may not be clear when the end customer has access to and has the ability to consume and benefit from the stand-ready service. In those scenarios, an entity generally will need to develop processes to estimate when the products are sold through to end customers and the service period to the end customer begins. We do not believe it would be appropriate to begin to recognize service revenue when the software license is transferred to the distributor on the basis that the software company cannot reliably estimate when the service period to the end customer begins; rather, we believe a reasonable estimate must be made. Oftentimes, it will be reasonable for the estimate to be based on available sell-through data for a portfolio of similar transactions.

Question F240

What is an appropriate measure of progress for a combined performance obligation comprised of software-as-a-service and professional services?

Interpretive response: The circumstances addressed by this question – i.e. a combined performance obligation comprises SaaS and professional services that are *not* distinct from each other – should be distinguished from the more common circumstance where SaaS and professional services are separate performance obligations. This question does not address the latter circumstance.

When evaluating a combined performance obligation, determining the nature of that performance obligation is vital to both (1) determining whether a performance obligation is satisfied over time and (2) assigning an appropriate, single measure of progress to those that are satisfied over time.

The nature of the entity's overall promise to the customer in a SaaS arrangement is to provide the customer with the service of access to its hosted application – i.e. the entire purpose of a SaaS arrangement is to permit the customer to access the SaaS provider's hosted application or platform. We do not believe that this conclusion changes when professional services are provided, typically upfront, that are not distinct from the SaaS offering. Question C280 discusses the circumstances in which the SaaS offering and related professional services (e.g. customization or implementation services) that are not 'set-up activities' (see Question C220) are not distinct from each other.

It is also important that, typically, the basis for concluding that a SaaS performance obligation is satisfied over time is that the customer consumes and receives benefit throughout the contract period from the SaaS provider's performance of providing access to its hosted software – i.e. the customer in a SaaS arrangement benefits throughout the arrangement period from having the ability to access the hosted software as needed.

In view of the two preceding paragraphs, we believe the single measure of progress toward complete satisfaction of the combined performance obligation will typically be driven by what an appropriate measure of progress would be for the promise to provide the SaaS if it were evaluated on a stand-alone basis. Thus, we believe a time-based measure of progress will typically be appropriate, recognizing revenue *over the period the customer has the ability to* *consume and receive benefit from its access to the SaaS*. This means an entity would generally not begin to recognize revenue on the combined performance obligation before the customer 'goes live' – i.e. even if the non-distinct professional services commence (and even if they are completed) before the 'go-live' date, no revenue generally should be recognized on the combined performance obligation before the go-live date. The transaction price allocated to the combined performance obligation will, therefore, be recognized over the SaaS period beginning from the go-live date.

Topic 606 does not provide explicit guidance to this effect. However, an example of SaaS and non-distinct professional services (performed upfront) was discussed by the TRG at its July 2015 meeting. While there were some differences of view about some aspects of that example, TRG members generally agreed with the view of the FASB and IASB staffs that the most appropriate measure of progress was one based on the SaaS, with progress being measured over the SaaS period from the go-live date such that no revenue would be recognized during the period the professional services are performed.

Question H230 discusses the effect of using this measure of progress on the accounting for fulfillment costs incurred before recognizing revenue on the performance obligation.

Example F240.1
Software-as-a-service and non-distinct services

SaaS Provider enters into a contract with Customer to provide Customer with access to its hosted research application for three years on a SaaS basis – i.e. Customer does not have the right to take possession of the hosted software. Customer needs access to a research tool that can meet certain specifications before it can migrate from its legacy research tool. SaaS Provider agrees, as part of the contract, to develop and implement the necessary additional search functionality to its hosted application before Customer goes live with the research tool in six months. SaaS Provider begins the customization efforts immediately after contract inception.

SaaS Provider frequently sells access to its SaaS on a stand-alone basis (i.e. without customization or other professional services) and has concluded that its performance obligation to provide SaaS is satisfied over time on the basis that the customer receives and consumes benefits from SaaS Provider's performance of providing access to the hosted application as SaaS Provider performs – i.e. the customer benefits from having the research tool available to it whenever needed during the arrangement period.

Consistent with Question C280, SaaS Provider concludes that the customization services, which involve proprietary knowledge of and access to its existing software code, and the SaaS offering in this contract are not distinct from each other – i.e. they constitute a single, combined performance obligation.

SaaS Provider concludes that the combined performance obligation is satisfied over time on the same basis as it had previously concluded its SaaS offering, when sold on a stand-alone basis, is satisfied over time. SaaS Provider then concludes that a time-based measure of progress, with recognition of revenue commencing at 'go-live', is appropriate for the following reasons.

— Even with the customization services being part of the contract, the fundamental nature of SaaS Provider's promise to Customer is to provide Customer with access to its SaaS that meets Customer's needs, which Customer consumes and receives benefit from on a generally equal basis throughout, and only *during*, the three-year period following the go-live date.

— Customer will not begin to consume and receive benefit from the SaaS before go-live – i.e. if go-live never came, Customer would have consumed and received no benefit from the contract, even if SaaS Provider had successfully customized the hosted application to Customer's specifications.

— From the go-live date, SaaS Provider's efforts to give Customer access to its hosted research application are expected to be even throughout the three-year period.

SaaS Provider concludes that its costs to customize its hosted SaaS application are within the scope of Subtopic 350-40 on internal-use software. Consequently, SaaS Provider follows the guidance in Subtopic 350-40 in accounting for those costs.

Question F250

What is an appropriate measure of progress for a 'hybrid SaaS' arrangement in which the on-premise software license and the software-as-a-service (SaaS) element are a single performance obligation?

Interpretive response: Question C310 outlines how an entity should evaluate whether the on-premise and SaaS elements are distinct from each other, and therefore separate performance obligations, in hybrid SaaS (or hybrid cloud) arrangements.

Similar to the analysis of Question F230, the determination of the measure of progress for a combined performance obligation that includes an on-premise software license and a SaaS element depends on determining the nature of the entity's overall promise to the customer, and important to that consideration may be the reason(s) why the entity decided that the on-premise element(s) and the SaaS element(s) are not distinct from each other.

We believe that, in most cases, the nature of the entity's overall promise to the customer when a combined performance obligation includes an on-premise software element and a SaaS element – i.e. as described in Question C310, the on-premise software element and the SaaS element are *not* distinct from each other – is to provide access to a combined functionality that depends significantly on both elements. This is because the basis for the conclusion that the on-premise element and the SaaS element are not distinct from each other in these cases is the integrated nature of the two elements' functionalities – i.e.

typically, the basis for any conclusion that an on-premise element (A) and a SaaS element (B) are not distinct from each other will be that A and B depend upon each other (i.e. work together) to provide combined functionalities that are integral to the customer's ability to derive its intended benefit from the hybrid SaaS solution.

Consequently, consistent with most other 'access-type' performance obligations (e.g. pure SaaS arrangements or distinct hosting services provided in a software licensing arrangement), we believe a time-based measure of progress will frequently be appropriate because the customer obtains generally equal benefit from its access to the integrated offering throughout the arrangement period and the entity's efforts to provide that access (which, typically, principally consist of its efforts to maintain availability to the customer of the SaaS features – efforts to transfer the on-premise software license are generally minimal).

Question F260

How should an entity measure progress in a combined performance obligation satisfied over time that includes a software license and software customization (or complex implementation services)?

Interpretive response: If a combined performance obligation that includes a software license(s) and customization or complex implementation services is satisfied over time (see Question F200), the performance period will conclude at the point in time the services are complete. Because software licenses provide customers with a right to use software (see Question F20), rather than a right to access software, once the customization or complex implementation services are complete, there is no further performance required of the software entity – i.e. the performance obligation is completely satisfied. This rationale was enumerated by the FASB in the Basis for Conclusions to ASU 2016-10 (BC68).

Frequently, an appropriate measure of progress will be an input-based measure such as one based on costs incurred as compared to total expected costs (i.e. the cost-to-cost method) or labor hours incurred as compared to total expected labor hours. While Topic 606 permits some flexibility in selecting a measure of progress for performance obligations satisfied over time, that selection is not a 'free choice', the selection must reasonably reflect progress toward complete satisfaction of the performance obligation. In software customization or complex implementation scenarios, we generally would not expect a time-based measure to reasonably reflect the likely *uneven* performance of the services while output measures that provide 'direct measurements of value to the customer' will not frequently be available.

When applying a cost-to-cost method, if the combined performance obligation includes a third-party software license (i.e. the third-party license is not distinct), the entity should consider the 'uninstalled materials' guidance in paragraph 606-10-55-21(b). That is, it may be appropriate for the entity to recognize revenue to the extent of the entity's cost of the license if the criteria in that paragraph are met.

Comparison to legacy US GAAP

In general, it is likely entities accounting for combined performance obligations of this nature that are satisfied over time will measure progress toward complete satisfaction of those performance obligations similarly to how software entities measured progress toward completion of similar contract accounting elements under legacy US GAAP.

However, because the completed contract method, which used to be permitted in some circumstances, is not permitted under Topic 606, entities that previously applied that method to their combined software and essential services elements (e.g. when unable to make dependable estimates of efforts to complete) may see a change in their accounting for those combined performance obligations (e.g. applying a zero margin approach).

Question F270

How should an entity measure progress in a combined performance obligation satisfied over time that includes *both* software customization and rights to unspecified updates, upgrades and enhancements?

Interpretive response: A software entity may enter into a software licensing arrangement that includes *both* (1) customization and (2) rights to unspecified updates, upgrades and enhancements (and/or rights to use unspecified additional software products) and for which both of those items are not distinct from the software license. This may not be a frequent occurrence in a single software license arrangement, but might occur in a contract for multiple software licenses that are not distinct from each other (see Question C140) wherein some of the software is significantly customized or modified, while other applications upon which the 'system' (or 'solution') depends require updates or upgrades to maintain their utility within the system.

Despite the potential complexity of the determination, Topic 606 requires the entity to apply a *single* measure of progress to that combined performance obligation. Regardless of how many promised goods or services comprise the combined performance obligation, determining the nature of that combined performance obligation remains pivotal to assessing both (1) whether the performance obligation is satisfied over time and (2) an appropriate measure of progress to apply to the performance obligation if it is satisfied over time. The TRG discussed this concept at its July 2015 meeting and the members generally agreed that, in determining the nature of a combined performance obligation, an entity should consider the reasons why it decided that the goods or services are not distinct from each other. However, in arrangements of the nature in question, there may be some competing evidence to consider. For example:

- A software license and customization services are generally only combined when the customization is 'significant'. Insignificant customization would neither meet the 'significant customization or modification' factor in paragraph 606-10-25-21, nor lead to a conclusion that the software entity is providing a 'significant integration service' using the software license and the customization services as inputs. Therefore, the customization efforts in a combined performance obligation would typically be viewed as significant.
- In general, the basis for a conclusion that a software license and unspecified item rights are not distinct from each other in these cases is the *integral* nature of the updates, upgrades, enhancements or additional software products to the continued utility of the software license.

Significant judgment will be required to select an appropriate measure of progress in a scenario of this nature. However, whatever measure of progress is chosen, we believe it would not be in accordance with the guidance to either:

- default – i.e. without appropriate consideration – to a time-based measure of progress for the combined performance obligation; or
- adopt a measure of progress that would recognize all of the revenue attributable to the combined performance obligation before the customer's right to unspecified items expires.

After appropriate consideration, a time-based measure of progress, commencing at the point in time the customer can begin to use and benefit from the software licensed under the arrangement may be appropriate. This may be before or only after the software customization is complete, depending on the facts and circumstances. For example, commencement before completion of the customization may be appropriate if the customer obtains control of the software license before the entity undertakes the customization services (see Question F200) and is provided unspecified updates, upgrades and enhancements released during the customization period.

It would generally not be appropriate to follow a 'zero gross-margin' approach – i.e. recognize revenue to the extent of costs incurred (e.g. in customizing the software) until the customization is complete and then recognize the remainder of the transaction price allocated to the performance obligation ratably (i.e. on a time basis) over the remaining period the customer has rights to unspecified items. A 'zero gross-margin' approach was generally an acceptable method for recognizing revenue under legacy US GAAP when the arrangement included services essential to the software (e.g. services to significantly modify or customize the software) and PCS or hosting services for which the software entity did not have vendor-specific objective evidence of fair value (VSOE). However, we do not believe it would be appropriate under Topic 606 because the cost-to-cost (at zero margin) method employed before the customization services' completion and the time-based method employed subsequently would constitute the use of multiple measures of progress for a single performance obligation, which is prohibited under Topic 606 (paragraph 606-10-25-32).

Question H230 discusses the effect of using a measure of progress on the accounting for fulfillment costs when that results in incurring those costs before recognizing any revenue on the performance obligation.

Comparison to legacy US GAAP

The requirement to use a *single* measure of progress and its effect on an entity's ability to follow a 'zero gross margin' approach for arrangements of the nature in this question will represent a change for entities that previously used the zero gross margin approach in those cases.

Entities were not required to use the zero gross margin approach. It was generally acceptable for entities to apply the completed contract method until the customization services were complete (i.e. to defer all of the revenue and the costs) and then recognize the revenues and related costs ratably over the PCS or hosting period. Meanwhile, use of the completed contract method was *required* if it was not reasonably assured that no loss would be incurred under the arrangement. For entities following the completed contract method for these arrangements, the accounting under Topic 606 will also likely result in a change unless the entity concludes that a time-based measure of progress, commencing only after completion of the customization services, is appropriate.

In addition to the above discussion, there will be substantial differences in accounting that will result from the vastly different separation guidance – i.e. the population of arrangements that include one or more software licenses, customization services, and rights to unspecified items that will be accounted for as a single performance obligation will likely be much smaller.

Question F275

Over what time period should an entity recognize revenue when the performance obligation has an indefinite term?

Background: An entity may enter into a contract to provide an over-time performance obligation in perpetuity. For example, a gaming company may provide access to its web-based content for an indefinite term.

Interpretive response: Topic 606 does not explicitly address how an entity should determine the period of revenue recognition for an indefinite term. However, the underlying principle is that an entity recognizes revenue by measuring progress toward complete satisfaction in a manner that depicts its performance. This typically involves estimating the entity's progress toward completion. Therefore, we believe it is appropriate to estimate the period in which the entity expects to perform. [606-10-25-31]

When the contract includes an indefinite term, we believe the entity should consider all relevant factors to determine the appropriate period including, but not limited to the:

— customer life – e.g. average period of customer usage; and
— expected life of underlying technology, product or IP.

The period the entity estimates depends on the nature of the service, and facts and circumstances about the entity and the customer. The period should best depict the entity's performance in fulfilling its obligation to that customer.

— In some cases, it will be appropriate to recognize revenue over a period that is *less than* the life of the underlying technology, product or IP when an entity has reliable data to support that the entity is transferring control of the service over the customer life.

— In other cases, an entity may expect to provide services to the customer throughout the life of the underlying technology, product or IP, or it may not have reliable data to support a shorter customer life.

Question F280

When is it appropriate to use the 'as-invoiced' practical expedient for arrangements that contain a change in the unit price under a time and materials (T&M) or transaction-based contract?

Interpretive response: At the July 2015 TRG meeting, TRG members agreed that an entity is not precluded from applying the 'as-invoiced' practical expedient in situations in which the price per unit changes during the duration of the contract. The FASB and IASB staff and TRG members noted that application of the practical expedient in those situations involves an analysis of the facts and circumstances of the arrangement. The objective of the analysis is to determine whether the amount invoiced for goods or services reasonably represents the value to the customer of the entity's performance completed to date. For example, a contract to purchase electricity at prices that change each year based on the observable forward market price of electricity would qualify for the practical expedient if the rates per unit reflect the value of the provision of those units to the customer.

Another example discussed by the TRG was an IT outsourcing arrangement where the hourly rate charged for the activities underlying the IT service obligation reflects the increased complexity of the underlying activities that will be performed earlier in the contract period versus later in the contract period, requiring more experienced (i.e. more costly) personnel to perform the activities at the outset. The example also appears to consider the effect of a 'learning curve' – i.e. in most circumstances, personnel will, over time, become more efficient at performing the same tasks.

Consequently, there are instances where a change in the per unit pricing will not preclude use of the practical expedient; however, considering the TRG discussion and FASB/IASB staff memos from the July 2015 TRG meeting, the reasons for the change in the per unit pricing must be substantive (e.g. for a valid business reason, such as declining costs or changes in the relevant index) and the amount of the change must approximate the change in value to the customer. The SEC observer to the TRG stated that this latter conclusion *must be supported* (e.g. supported by the change in a forward pricing curve in the case of electricity, a change in the Consumer Price Index or a change in labor data that is relevant to the entity's costs of providing the goods or services).

Example F280.1

Changes linked to an observable index or rate

Scenario 1: Changes in unit rates linked to an observable index

SaaS Provider enters into a contract with Customer to provide Customer with access to its hosted transaction processing application for three years on a SaaS basis – i.e. Customer does not have the right to take possession of the hosted software. Fees for the SaaS are transaction-based, starting at $0.90 per transaction for the first year and then adjusting each year by an amount equal to the change in the Consumer Price Index (CPI).

Even though the fees per transaction Customer will pay will change in Years 2 and 3 of the arrangement, SaaS Provider concludes that it can still apply the as-invoiced practical expedient. This is on the basis that, even though Customer will pay a higher per-transaction fee for the SaaS in Year 2 than in Year 1 and in Year 3 than in Year 2, the change in fee reflects the change in the value of the services to Customer (resulting from inflation of the related currency), rather than a change in the price Customer is paying for the same service with the same value to Customer. As a result, SaaS Provider concludes that the fees it will receive during each period of the arrangement appropriately reflect the value to the customer of the entity's performance of providing access to its hosted application in each period of the arrangement.

Note that we do not believe the conclusion in this example would be affected by the amount of the expected changes in CPI during the contract period – i.e. the conclusion would not be affected by whether expected CPI changes were nominal or significant. Rather, the key consideration in this example is that the fees each period are reflective of the value to the customer of the service provided in that period even though the actual monetary amounts paid are not the same. To the extent that costs which are captured in an index such as CPI are reflective of the cost of providing the service, how the changes in price relate to CPI may inform the analysis as to whether the fees are commensurate with the value to the customer each period of the arrangement.

Scenario 2: Changes in unit rates linked to greater of an observable index or fixed change

Assume the same facts as Scenario 1 except that SaaS Provider charges $0.90 per transaction for the first year and then adjusts each subsequent year by an amount equal to the greater of the change in the Consumer Price Index (CPI) or 7%. CPI currently is expected to increase at 2% for the upcoming year and SaaS Provider's costs are not expected to increase more than CPI.

In this fact pattern, the price is expected to increase 7% each year which is not consistent with inflation or SaaS Provider's historical pricing or cost trends. As such, SaaS Provider concludes that it cannot use the as-invoiced practical expedient because the change is not supported by valid business reasons, such as being commensurate with the increase in costs of providing the service or changes in CPI.

Example F280.2

Different per unit rates within a performance obligation

ABC Corp. licenses software to Customer and also agrees to provide implementation services (which are determined to be a single performance obligation that is distinct from the software license – see Questions C240 – C260). There is a fixed fee of $1,000,000 in the contract, which is listed as a 'license fee'. There is no stated fee total for the implementation services; fees for the services will be billed to the customer on a time and materials (T&M) basis using a rate card that differentiates hourly rates by the ABC employee's role (e.g. $325 per hour for a senior developer and $160 per hour for an associate engineer). The rates on the rate card reflect observable hourly rates ABC charges customers for its professional services on a stand-alone basis. ABC keeps tight control over the hourly rates it charges for its professional services.

The rate card means that, despite the fact that the implementation services are a single performance obligation, ABC will bill Customer a different hourly rate depending on which ABC employee is performing the task generating the billing.

ABC concludes that it is appropriate to allocate the hourly T&M billings entirely to the implementation services performance obligation and the fixed fee of $1,000,000 entirely to the software license. This is because:

— the variable payments for the implementation services relate specifically to those services;

— the hourly rates are at ABC's observable stand-alone selling price for those services, such that the transaction price for the implementation services resulting from the T&M billings will meet the transaction price allocation objective; and

— the stand-alone selling price for the software license is highly variable such that allocating the entire fixed fee to the software license, based on a residual approach to estimating the stand-alone selling price for the license, is also reasonable.

ABC will recognize the revenue attributable to the software license when Customer obtains control of that license (see Questions F10 – F90).

With respect to the implementation services, assuming the rate card differences reflect (1) substantive differences between the tasks the respective ABC employees will perform – e.g. a senior developer will be performing tasks commensurate with his/her skill-set that an associate engineer cannot perform, and not performing tasks an associate engineer can perform – and (2) ABC's costs of those services (e.g. the hourly rate difference is reasonable in relation to ABC's employee costs), use of the practical expedient to recognize revenue for the implementation services performance obligation may be appropriate.

Question F290

Do upfront fees paid by the customer preclude use of the 'as-invoiced' practical expedient?

Interpretive response: In general, fees paid upfront that are not directly linked to the value of goods or services transferred to date preclude the use of the practical expedient for a specific performance obligation. This is because the Basis for Conclusions to ASU 2014-09 (BC167) states that the 'as-invoiced' practical expedient "is appropriate if the amount of consideration that the entity has a right to invoice corresponds directly with the value to the customer of each incremental good or service that the entity transfers to the customer".

Put another way, the practical expedient was designed to apply when the transaction price varies in direct proportion to a variable quantity of goods or services transferred to the customer – i.e. where the transaction price = a fixed per unit price (see Question F280) × a variable quantity of units (TP = P × Q).

Therefore, in general, fees paid upfront that are not directly linked to the value of goods or services provided to date would preclude use of the practical expedient for a given performance obligation.

However, at the July 2015 TRG meeting, it was generally agreed that an upfront or back-end fee, not linked to units transferred, would not, in isolation, preclude use of the practical expedient in all circumstances.

While it is clear why an upfront fee, unrelated to the P × Q aspect of the arrangement, that reflects the value of other goods or services provided to the customer would not preclude use of the practical expedient, we believe the TRG discussion also suggested that an insignificant upfront fee (in relation to the expected P × Q consideration) should not preclude use of the practical expedient. We believe the latter conclusion is premised, principally, on a materiality basis that an insignificant upfront fee would not:

- necessarily mean that the amounts later invoiced do not reflect the value to the customer of the goods or services being transferred; or
- substantively affect the overall measure of progress, based on units transferred to the customer, toward satisfaction of the performance obligation.

In contrast, a more-than-insignificant upfront fee, that is not linked to the transfer of goods or services to the customer, would preclude use of the 'as invoiced' expedient. This is because the upfront fee in that case would typically suggest that amounts to which the entity has a right to invoice in later periods do not reflect the value to the customer of the goods or services transferred during the applicable invoice period (i.e. the value of those goods or services includes a portion of the upfront fee). Recognition of the upfront fee using one measure of progress (e.g. a time-based measure) and applying the 'as invoiced' expedient to variable fees would constitute using multiple measures of progress for a single performance obligation, which is prohibited under Topic 606. This would be the case even if the measure of progress applied to the upfront fee is an output-based measure such as one based on units produced – an output-based measure selected in accordance with paragraph 606-10-55-17 is not the same measure of progress as the 'as-invoiced' practical expedient.

Judgment will be required to determine whether an upfront fee is insignificant such that it does not preclude use of the practical expedient.

Example F290.1

Upfront fees and application of the practical expedient

SaaS Provider enters into a contract with Customer to provide Customer with access to its hosted transaction processing application for three years on a SaaS basis – i.e. Customer does not have the right to take possession of the hosted software. Transaction-based fees apply; the Customer will pay SaaS Provider $0.90 per transaction throughout the contract period, billed quarterly in arrears. There are no other promised goods or services in the contract.

Scenario 1

In addition to the transaction-based fees, Customer is required to pay a nonrefundable upfront fee of $12,000. SaaS Provider, based on relevant, predictive experience, expects transaction-based fees from the arrangement of approximately $480,000.

The $12,000 nonrefundable upfront fee does not relate to a promised good or service because there are no promised goods or services other than the SaaS in the contract. However, the upfront fee may not preclude SaaS Provider from using the practical expedient to recognize revenue in this case on a materiality basis. This is because, in this scenario, the insignificance of the upfront fee does not change that the transaction-based fees earned each period reflect the value to the customer of its ability to process those transactions during that period. In addition, assuming Customer incurs between $35,000 and $50,000 in transaction-based fees each quarter, recognition of the upfront fee would not have a significant effect on either (1) the revenue recognized or (2) the overall pattern of revenue recognition (suggesting use of multiple measures of progress for the single performance obligation).

— On a straight-line basis, recognition of the upfront fee would only affect quarterly revenue recognized by $1,000

— Recognition on an output (i.e. units produced) basis would affect quarterly revenue by $875 to $1,200, recognizing less in quarters with less transaction volume (e.g. $875 recognized in a month with $35,000 in transaction-based revenue) and more in quarters with higher transaction volume (e.g. $1,200 in a month with $50,000 in transaction-based revenue).

Scenario 2

In addition to the transaction-based fees, Customer is required to pay a nonrefundable upfront fee of $48,000. SaaS Provider, based on relevant, predictive experience, expects transaction-based fees from the arrangement of approximately $480,000.

In this scenario, the $48,000 upfront fee is significant. Because the upfront fee does not reflect a commensurate payment for goods or services transferred (or partially transferred) to the customer at the time it is paid, it suggests the fees to which SaaS Provider will have a right to invoice each period – i.e. for transactions processed that period – will not reasonably reflect the value of the entity's performance for that period. In addition, the significant upfront fee substantively changes the character of the revenue recognition for this arrangement from one based on the TP = P × Q formula upon which the practical expedient is based. Therefore, the practical expedient should not be applied to this arrangement.

Even though the practical expedient does not apply, SaaS Provider may be able to recognize the revenue attributable to the P × Q formula (i.e. the $480,000 in expected transaction-based fees) in a manner that is generally consistent with the recognition that would result from applying the practical expedient. That is, SaaS Provider may be able to recognize the transaction-based fees in the period in which the transactions are processed on the SaaS platform as a result of the variable consideration allocation guidance that applies, in many cases, to series of distinct goods or services (see paragraphs 606-10-32-39 – 32-40). See *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*.

Scenario 3

In addition to the transaction-based fees, Customer is required to pay quarterly fixed fees, in arrears, of $4,000 (for a total of $48,000). SaaS Provider, based on relevant, predictive experience, expects transaction-based fees from the arrangement of approximately $480,000.

Judgment will be required to determine whether the practical expedient can be applied in this scenario given the ambiguity of the TRG discussion.

On one hand, the fixed fee, in effect, changes the per unit transaction-based fee each period. For example, if Customer processes 40,000 transactions in the first quarter, the net per-transaction fee is $1.00 per transaction (([40,000 transactions × $0.90 = $36,000] + $4,000 = $40,000) ÷ 40,000 transactions), while if Customer processes 50,000 transactions, the net per-transaction fee is $0.98 (([50,000 transactions × $0.90 = $45,000] + $4,000 = $49,000) ÷ 50,000 transactions). Unless the change from period to period in the net per-transaction fee reflects changing value to the customer (see Question F280), one might conclude that use of the practical expedient is not permitted in this situation.

Alternatively, SaaS Provider might still conclude that the practical expedient can be applied if there is a narrow range of per-transaction prices that could reasonably reflect an appropriate 'value to the customer' and that range includes those reasonably expected to arise – e.g. if per transaction fees of anywhere within a range of $0.96 – $1.01 would represent value to the customer and SaaS Provider reasonably expects to be within that range throughout the contract.

Question F300

Does a contractual minimum preclude the use of the 'as-invoiced' practical expedient?

Interpretive response: In general, a contractual minimum quantity that the entity validly expects the customer to easily surpass would not be considered a substantive minimum and would not preclude the use of the 'as-invoiced' practical expedient.

In contrast, if the contractual minimum is such that there is a reasonable possibility that the customer will not exceed that minimum, the entity should not apply the practical expedient. Rather the entity should apply the general guidance on determining the transaction price (including the general constraint on variable consideration) – see *Chapter D – Step 3: Determine the transaction price* – and select an appropriate measure of progress for that performance obligation. For example, consider a SaaS arrangement with transaction-based pricing for which there is a reasonable possibility that the customer will not exceed the minimum quantity of transactions (*and for which the entity cannot apply the series/variable consideration allocation guidance* – see *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*). In that scenario, the SaaS provider *may* conclude that a time-based measure of progress applied to the sum of the minimum transaction-based fees and a constrained estimate of transaction-based fees above that minimum (if any) is appropriate.

At the November 2016 TRG meeting, the TRG discussed one alternative (amongst two others), proposed to be applied to minimum guaranteed royalties for a license of symbolic IP (i.e. a right to access license). Under that alternative, the entity would recognize the minimum guarantee (fixed consideration) using an appropriate measure of progress and recognize royalties above the guaranteed amount only when cumulative royalties exceed the minimum guarantee. Some have questioned whether this approach would be acceptable for a SaaS arrangement with transaction- or usage-based fees subject to a guaranteed minimum – e.g. a situation where the customer will pay $0.90 per transaction subject to a guaranteed amount of $180,000 if the customer's transaction volume does not exceed 200,000 transactions. We do not believe the TRG alternative applicable to licenses of symbolic IP can be extrapolated to SaaS arrangements. This is because the TRG right to access license alternative is premised on application of the royalties constraint to the sales- or usage-based royalty (see paragraphs 22-24 of TRG Agenda Paper No. 58), which only applies to licenses of IP, rather than the general constraint on variable consideration, which applies to transaction-based fees in a SaaS arrangement. Application of the general constraint results in the accounting described in the preceding paragraph.

Example F300.1
Non-substantive minimum

SaaS Provider enters into a contract with Customer to provide Customer with access to its hosted transaction processing application for three years on a SaaS basis – i.e. Customer does not have the right to take possession of the hosted software. Fees for the SaaS are transaction-based at $0.90 per transaction throughout the three-year term, subject to an annual minimum of $90,000 ($0.90 × 100,000 transactions).

SaaS Provider has a number of contracts similar to the one with Customer and relevant experience suggests, barring some unforeseen event, that Customer will process more than 250,000 transactions the first year (a 'ramp up' period) and more than 350,000 in the each of the second and third years.

Because SaaS Provider expects Customer will far exceed the annual minimum each year of the contract, SaaS Provider concludes that the annual minimum, which SaaS Provider includes in its contracts to ensure a minimum recovery of its fixed costs if all of its customers paid only their contractual minimums annually, is not a substantive clause of the contract. Therefore, SaaS Provider concludes that the contractual minimum does not preclude the use of the 'as-invoiced' practical expedient for this contract.

Example F300.2
Substantive minimum, assume variable consideration allocation guidance does not apply

SaaS Provider enters into a contract with Customer to provide Customer with access to its hosted transaction processing application for three years on a SaaS basis – i.e. Customer does not have the right to take possession of the hosted software. Fees for the SaaS are transaction-based at $1.00 per transaction throughout the three-year term, subject to a cumulative minimum of $270,000 ($1.00 × 90,000 transactions × 3 years).

SaaS Provider has a number of contracts similar to the one with Customer and that relevant experience suggests that Customer will process between 88,000 and 98,000 transactions each year. Using an expected value method, SaaS Provider estimates a total transaction volume of 280,000. SaaS Provider has determined that its expected value estimate of the transaction-based variable consideration does not need to be constrained because (1) its evidence is based on substantial history with similar arrangements and (2) there is negligible risk of any cumulative revenue reversal being 'significant' given the amount of the contractual minimum and the fact that the performance obligation is satisfied over time. That is, SaaS Provider concludes that its estimate of the transaction-based fees is unlikely to change significantly and any effect of a change in estimate (e.g. $10,000 change in estimated transaction-based fees) will only apply to the extent of progress to date in satisfying the performance obligation.

SaaS Provider recognizes the $280,000 transaction price ratably over the three-year SaaS period. SaaS Provider concludes that a time-based measure of progress appropriately reflects its generally equal efforts to provide access to Customer throughout the three-year term. To the extent SaaS Provider's estimate of the transaction price (including consideration of the constraint) changes, SaaS Provider will record a cumulative effect adjustment as necessary to true up revenue recognized to date.

Alternatively, SaaS Provider may determine that an output-based measure is an appropriate measure of progress to apply to the performance obligation – i.e. recognizing actual transaction-based fees earned as compared to total expected transactions that will be processed through the hosted application – because the number of transactions processed provides a direct measurement of the value Customer has obtained to date from SaaS Provider's performance of providing Customer with access to its hosted application. In concept, to the extent SaaS Provider's estimate of the transaction price (including consideration of the constraint) changes – i.e. because of changes in the estimate of transactions Customer will process using the application – SaaS Provider would record a cumulative effect adjustment to true up revenue recognized to date. However, mathematically, no cumulative effect adjustment would result when using this measure of progress unless SaaS Provider's estimate of total transactions that will be processed falls below the contractual minimum.

Question F310

Do contractual provisions such as tiered-pricing, rebates, credits and refunds preclude the use of the 'as-invoiced' practical expedient?

Interpretive response: SaaS arrangements frequently include provisions whereby either (or both):

— a per-usage or per-transaction fee decreases based on volume *prospectively*. For example, the customer pays $0.90 per transaction for the first 100,000 transactions processed by the hosted application; $0.80 for the next 200,000 transactions; and $0.75 for all those thereafter. Tiered pricing of this nature may exist for an entire SaaS arrangement period or it may reset multiple times (e.g. each year or each month) during the arrangement period.

— the customer is entitled to a refund or rebate (of cash previously paid) or a credit that can be applied against future invoices if it passes a particular usage or transaction volume. Often these provisions are accompanied by tiered-pricing. For example, assume the same tiered pricing as in #1; however, when the customer passes into a lower pricing tier, it receives that pricing *retrospectively* for all prior transactions through a refund, rebate or a credit.

Such provisions, in effect, either or both (1) create variable consideration (e.g. refunds, rebates or credits) or (2) create different rates per unit at different times during the contract (e.g. tiered pricing).

Tiered pricing

The circumstances in which a change in the price per unit, such as occurs in a tiered pricing scenario, is permitted without precluding use of the as-invoiced practical expedient are addressed in Question F280.

Rebates, refunds, or credits

Variable consideration (whether created by expected refunds, rebates, or credits or something else) will generally preclude use of the as-invoiced practical expedient to recognize revenue because the amount to which the customer has a right to invoice will not, at least until the customer achieves the lowest pricing tier, reflect the amount to which the entity expects to be entitled. It is prohibited from recognizing the invoiced amount as revenue because there is an expectation of later price concessions. The expectation of later price concessions (i.e. changes to the invoiced price) also means the invoiced amounts do not reflect the value to the customer of the services provided.

Question F320

Does the 'as-invoiced' practical expedient permit an entity to wait until it has a right to invoice the customer to recognize revenue (rather than accrue for revenue earned, but not yet invoiced)?

Interpretive response: No. If an entity transfers goods or services to a customer during a reporting period, but does not have the right to invoice for those goods under the terms of the contract, the entity would still recognize revenue for those goods on an accrual basis. This would include situations in which the entity has to estimate quantities of goods or services transferred.

For example, an entity enters into a contract with a customer on a time and materials basis, but only bills the customer on a quarterly basis. In that scenario, when applying the as-invoiced practical expedient, the entity would recognize revenue as the time and materials are incurred rather than on a quarterly basis.

Question F330

Can the 'as-invoiced' practical expedient be applied to sales- and usage-based royalties promised in exchange for a software license?

Interpretive response: Typically, no. The 'as-invoiced' practical expedient is a practical expedient for measuring progress toward complete satisfaction of a performance obligation satisfied over time. If a software license is a separate performance obligation, it is satisfied at a point in time. Therefore, no measure of progress is applied. Practically however, because the recognition of sales- or usage-based fees promised in exchange for a distinct software license in accordance with paragraph 606-10-55-65 (i.e. the royalties recognition constraint) will be recognized when the customer's subsequent sales or usage occur, that recognition may be substantially similar to that which results from the 'as-invoiced' practical expedient.

The 'as-invoiced' practical expedient could, however, potentially be applied to a combined performance obligation that includes a software license if that performance obligation is satisfied over time. For example, if in the anti-virus software example in Topic 606 (Example 10, Case C), the customer paid the software entity an amount each month based on the number of viruses detected and quarantined, the entity would be able to apply the practical expedient, provided the other requirements for use of the expedient (e.g. with respect to upfront fees and changing rates, if applicable) were met.

Sales- or usage-based royalties promised in exchange for a license of IP

Excerpt from ASC 606-10

>>> Sales-Based or Usage-Based Royalties

55-65 Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize **revenue** for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.
b. The **performance obligation** to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

55-65A The guidance for a sales-based or usage-based royalty in paragraph 606-10-55-65 applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

55-65B When the guidance in paragraph 606-10-55-65A is met, revenue from a sales-based or usage-based royalty should be recognized wholly in accordance with the guidance in paragraph 606-10-55-65. When the guidance in paragraph 606-10-55-65A is not met, the guidance on variable consideration in paragraphs 606-10-32-5 through 32-14 applies to the sales-based or usage-based royalty.

>>> Example 60—Sales-Based Royalty Promised in Exchange for a License of Intellectual Property and Other Goods and Services

55-393 An entity, a movie distribution company, licenses Movie XYZ to a customer. The customer, an operator of cinemas, has the right to show the movie in its cinemas for six weeks. Additionally, the entity has agreed to provide memorabilia from the filming to the customer for display at the customer's cinemas before the beginning of the six-week airing period and to sponsor radio advertisements for Movie XYZ on popular radio stations in the customer's geographical area throughout the six-week airing period. In exchange for providing the license and the additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for Movie XYZ (that is, variable consideration in the form of a sales-based royalty).

55-394 The entity concludes that the license to show Movie XYZ is the predominant item to which the sales-based royalty relates because the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the related promotional goods or services. The entity will recognize revenue from the sales-based royalty, the only fees to which the entity is entitled under the contract, wholly in accordance with paragraph 606-10-55-65. If the license, the memorabilia, and the advertising activities were separate performance obligations, the entity would allocate the sales-based royalties to each performance obligation.

Scope of the guidance on sales- and usage-based royalties

The guidance included above does not apply to royalties promised in exchange for either:

— SaaS, including contracts that state a software license is part of the arrangement, but that license does not meet the criteria in paragraph 985-20-15-5 – see paragraph 606-10-55-54(a); or

— *sales* of software – i.e. a sale of the IP itself, rather than a license to that IP. For purposes of determining whether an arrangement is for the sale or the license of software, an entity follows the legal form of the contract – i.e. an entity does not attempt to determine if the license (even if exclusive and perpetual) is 'in substance' a sale of the IP.

Chapter A – *Scope* addresses determining whether a contract includes a software license that meets the criteria in paragraph 985-20-15-5.

Recognition requirements

Sales- or usage-based royalties promised in exchange for a license of IP are recognized at the later of:

— when the subsequent sales or usage occur; and
— the satisfaction or partial satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

The sales- or usage-based 'royalties recognition constraint' functions as a recognition constraint and the constraint on variable consideration in the general model does not apply. That is, revenue attributable to a sales- or usage-based royalty cannot be *recognized* before meeting one of the two 'later of' criteria in the preceding paragraph. [ASU 2016-10.BC71]

Application to royalties promised in exchange for a license to IP and other goods or services

An entity may be entitled to a sales- or usage-based royalty in exchange for a license of IP and other goods or services in the contract, which may or may not be distinct from the license. Licenses of IP are often bundled with other goods or services, with the consideration taking the form of a sales- or usage-based royalty for all goods or services in the contract. For example:

- software licenses are commonly sold with PCS and other services – e.g. implementation services – or hardware where there is a single consideration in the form of a sales- or usage-based royalty;
- franchise licenses are frequently sold with consulting or training services or equipment, with ongoing consideration in the form of a sales-based royalty; or
- biotechnology and pharmaceutical licenses are often sold with R&D services and/or a promise to manufacture the drug for the customer, with a single consideration in the form of a sales-based royalty.

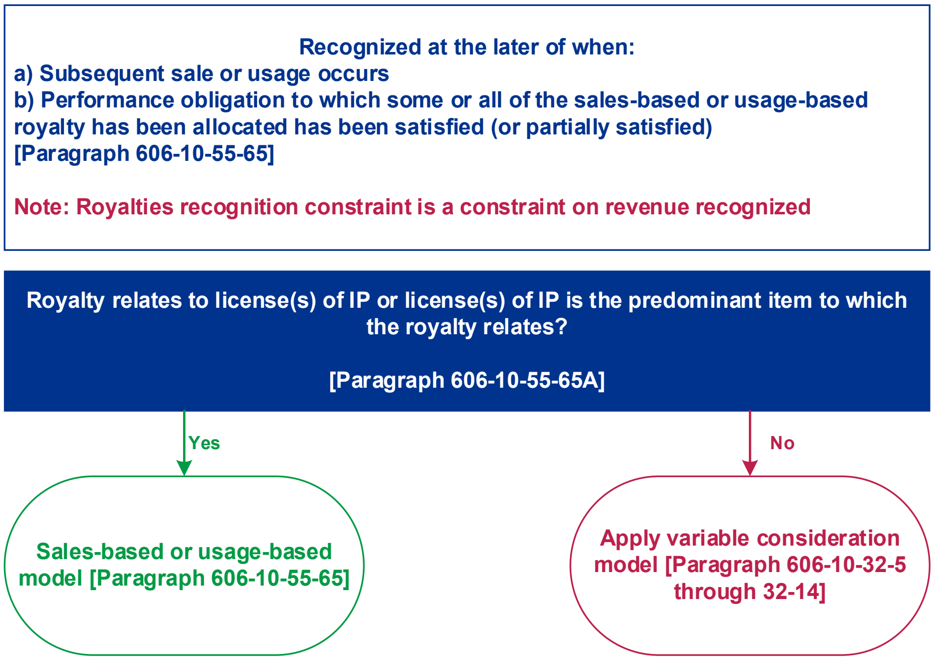
Sales- or usage-based royalties are subject to the 'royalties recognition constraint' when either:

- the royalty relates only to a license (or licenses) of IP; or
- a license (or licenses) is the predominant item to which the royalty relates (e.g. when the customer would ascribe significantly more value to the license(s) of IP than to the other goods or services to which the royalty relates).

Significant judgment may be required to determine whether a license is the predominant item in an arrangement. Topic 606 is not explicit about whether a license of IP is the predominant item only when it represents the major part or substantially all of the value or utility of the bundle or whether the exception would also apply when a license of IP is the largest single item in a bundle of goods or services.

An entity does not split a royalty that relates to a license of IP and another good or service into a portion that is subject to the royalties recognition constraint and a portion that is subject to the general guidance on variable consideration (including the constraint on variable consideration).

The figure below summarizes the requirements.



Illustrative Example F1

Usage-based fees in a software licensing arrangement

ABC Corp. licenses transaction-processing software to financial institutions. ABC executes a three-year term license with Customer. The software is functional IP and provides Customer with a right to use ABC's software (see Questions F10 and F20). Under the contract, ABC will receive a fixed fee of $200,000 plus additional usage-based fees of $0.01 per transaction processed by the software. There is no guaranteed minimum for the usage-based fees. For ease of illustration, this contract does not include any additional promised goods or services.

This is ABC's first contract with Customer, but ABC has similar license arrangements with a dozen other financial institutions similar to Customer. ABC is also aware that financial institutions such as Customer are required by law to process transactions of the nature ABC's software performs on behalf of its clients.

Despite the fact that ABC may be able to estimate a minimum amount of transaction-based fees to which it will reasonably be entitled from transferring the license to Customer, Topic 606 specifically prohibits recognition of transaction/usage-based fees before the customer's usage takes place.

This means that ABC will recognize $200,000 in revenue upon transfer control of the software license to Customer and will recognize additional transaction-based fees each period based on the number of transactions actually processed using the software during that period.

Comparison to legacy US GAAP

Under legacy US GAAP, a sales- or usage-based royalty – irrespective of whether it relates to the licensing of IP or other goods or services – is recognized only when the amount is fixed or determinable, which is typically when the subsequent sale or usage occurs. In addition, legacy US GAAP specifies that substantive milestone fees may be recognized once the milestone is achieved.

Under Topic 606, a sales- or usage-based royalty that relates (1) entirely to a non-license element or (2) to a license and a non-license element, but the license element is not the predominant item to which the royalty relates, will be included in the transaction price (subject to the constraint on variable consideration) and recognized sooner than under legacy US GAAP.

Question F335

Does the royalty exception apply for an agent if revenue is based on royalties from a customer's license of IP?

Interpretive response: It can. In certain arrangements, a software vendor (the principal) contracts with an agent to sell licenses to the software. In return for selling its licenses, the software vendor pays the selling agent a percentage of the sales- or usage-based royalties the software vendor earns from the end consumer. For example, a software company may contract with a software solutions consultant to sell software licenses to customers on behalf of the software vendor in return for a percentage of royalties received from customers based on software usage rates.

We believe that the selling agent could apply the sales-based royalty exception in this scenario if, and only if, the agency service is directly related to the licensor's provision of the software license *and* the software license is the predominant item to which the royalties relate. This is notwithstanding that the selling agent is not the party responsible for fulfilling the promise to transfer the software license.

Instead of applying the royalty exception, we believe the selling agent could apply the general guidance on estimating variable consideration. This is because paragraph 606-10-55-65 could be read to suggest that the royalty exception should apply only when it is promised in exchange for a license, not *arranging for* the provision of a license by another entity. An agent should be consistent in its application of the guidance to similar arrangements.

If the agency services do not relate directly to the licensor's provision of the software license (e.g. they instead relate to the licensor or another party's provision of a service, including a software-related service such as hosting or implementation services) or if the software license is not the predominant item to which the royalties relate, the royalty exception does not apply and the selling agent must apply the general guidance on estimating variable consideration (see *Chapter D – Step 3: Determine the transaction price*).

Question F340

Should a software entity account for a minimum guaranteed royalty promised in exchange for a software license as fixed consideration or in accordance with the 'royalties recognition constraint'?

Interpretive response: If sales- or usage-based royalties promised in exchange for a right-to-use license have a minimum guaranteed amount (that is not subject to other forms of variability such as a price concession), that amount is fixed consideration and should be recognized in the same manner as any other fixed consideration – i.e. it should be recognized when the customer obtains control of the license. This is the case regardless of the amount of the minimum.

Any royalties earned in excess of the minimum guaranteed amount should be accounted for as variable consideration, subject to the sales- or usage-based royalties recognition constraint – i.e. recognized when the customer's subsequent sales or usage occur.

Example F340.1

Software license with a guaranteed minimum

ABC Corp. enters into a five-year arrangement to license software to Customer. The software license provides the customer with a right to use ABC's software (see Questions F10 and F20). The consideration for the license is a sales-based royalty of 5% of the customer's gross sales of products that include ABC's software with a minimum guaranteed amount of $5 million.

At the point in time control of the software license is transferred to Customer (see Questions F10 – F90), the $5 million guaranteed royalty amount is recognized as revenue. Any royalties in excess of the $5 million minimum guaranteed amount are recognized when Customer's subsequent sales occur.

Question F350

Is it acceptable under Topic 606 to recognize revenue resulting from a sales- or usage-based royalty in a period subsequent to the period in which the customer's subsequent sales or usage occur if the entity does not receive reporting on those sales or usage timely (i.e. on a 'lag' basis)?

Interpretive response: No. If the consideration to which the entity is entitled from a sales- or usage-based royalty is not known in time for the entity's financial reporting (e.g. the entity will not receive a royalty report before it must file its Form 10-Q or Form 10-K), the entity must estimate the royalties to which it is entitled using the model for estimating variable consideration in paragraphs 606-10-32-5 through 32-9.

This position was articulated in remarks to the Annual SEC and Financial Reporting Institute Conference on June 9, 2016. Wesley R. Bricker, Deputy Chief Accountant in the Office of the Chief Accountant of the SEC, stated that, "The standard setters did not provide a lagged reporting exception with the new standard. Accordingly, I believe companies should apply the sales- and usage-based royalty guidance as specified in the new standard. The reporting, which may require estimation of royalty usage, should be supported by appropriate internal accounting controls."

We understand there are two views on whether entities should apply the variable consideration constraint when making this estimate based on the basis for conclusions to ASU 2016-10 (BC71). We believe entities should apply a consistent methodology to estimating these amounts.

- **Apply the constraint.** Under this view, entities apply the constraint because once the sale or usage has occurred (1) the royalty recognition constraint no longer applies and (2) the entity needs to estimate the transaction price because the ultimate amount of consideration is unknown.
- **Do not apply the constraint.** Under this view, entities do not consider the constraint because only one constraint model is applied to variable consideration. In the case of sales- or usage-based royalties related to IP, the royalty recognition constraint applies and not the general variable consideration constraint.

Example F350.1

Royalties report received after financial statements are issued

ABC Corp. enters into a five-year arrangement to license software to Customer. The software license provides the customer with a right to use ABC's software (see Questions F10 and F20). The consideration for the license is a sales-based royalty of 5% of Customer's gross sales to end customers of products that include ABC's software.

Customer uses an extensive distributor network such that it must receive reports on sales of its products before it can report royalties owed to ABC. This process takes time such that Customer provides royalties reporting to ABC generally only after ABC issues its quarterly financial reports.

ABC estimates sales for the quarter using a most-likely-amount or expected-value approach (see *Chapter D – Step 3: Determine the transaction price*) and the constraint on variable consideration. In making its estimate, ABC considers royalties earned in prior periods, royalties earned under similar arrangements and other knowledge about demand for Customer's products from consumers during the period in question.

Regardless of the quality and availability of information, ABC estimates royalties earned subject to the variable consideration constraint because it follows the first view described in Question F350.

Comparison to legacy US GAAP

Entities applying legacy US GAAP generally followed one of three approaches in practice; each approach was considered appropriate depending on the entity's particular facts and circumstances.

Approach 1: Recognize revenue in the period the royalty was earned based on reports received or other objective information available through the date of issuance of the financial statements.

Under this approach, the receipt of a royalty report or other objective information was viewed as a 'Type I' subsequent event that provided information about revenues earned during the prior fiscal quarter. Absent a royalty report, an entity may have used other objective evidence to quantify the royalty revenue earned. For example, an entity may have access to a system that provides visibility into units shipped by the manufacturer. It was generally not considered appropriate for an entity to estimate royalty revenues based solely on internal estimates such as historical sales trends. Under Approach 1, if the royalty report or other objective information was not available before the issuance of an entity's financial statements, revenues would not be recognized until a subsequent period.

Approach 2: Recognize revenue in the period the royalty report is received.

Under Approach 2, royalty revenue was recognized in the period in which the report was received. This method was appealing in situations in which royalty reports are received in an unpredictable manner at various dates that may be well after shipment of the related goods. In contrast to Approach 1, this approach suggested that receipt of a royalty report after period-end was more of a Type II subsequent event (i.e. the royalty amount only became fixed or determinable, and therefore recognizable, at the date of receipt of information by the entity).

Approach 3: Recognize revenue on a lag basis such that revenue earned in one period is recognized in the following period.

Under this approach, royalty revenue related to the prior period was recognized in the current period under a lag policy. This method resulted in all revenue related to a particular period being recognized in the subsequent period. This lag approach was similar to the lag approach to consolidating a subsidiary that is allowed under US GAAP (Subtopic 810-10).

None of the approaches outlined above that were applied under legacy US GAAP would be permissible under Topic 606. While it is clear that a 'lag' policy (Approach 3) or a policy that explicitly requires proof of the sales to end customers before recognition (Approach 2) are not permissible under Topic 606, even Approach 1 is different from Topic 606's requirements because, under Topic 606, even in the absence of objective information, the entity *must* estimate the royalties to which it is entitled using the best information it has available (i.e. regardless of whether that information is objective).

Question F360

Are payments with fixed monetary amounts, such as milestone payments, determined by reference to sales- or usage-based thresholds, a sales- or usage-based royalty?

Interpretive response: In general, if a fixed payment is determined solely by reference to a sales- or usage-based threshold (e.g. a fixed amount is payable to the entity once a cumulative sales or usage threshold is reached), it would constitute a sales- or usage-based royalty.

In contrast, if a fixed payment is determined (solely or partially) based on metrics or conditions that are not sales- or usage-based (and that are substantive), that payment would not be considered a sales- or usage-based royalty for purposes of determining whether the royalties recognition constraint applies.

Example F360.1

Milestone payments linked to sales- or usage-based amounts

ABC Corp. enters into a contract to license software to Customer. There are no other promised goods or services in the contract. The contract contains payment terms that include a milestone payment that is payable to ABC once Customer has reached a specified level of sales (e.g. a $10 million milestone payment is due after sales of $100 million have been reached).

The milestone payment is a sales-based royalty because the payment depends entirely on subsequent sales of ABC's software by Customer. Therefore, because the sales-based royalty relates solely to a license of IP (i.e. the software license granted to Customer), ABC applies the royalties recognition constraint in accounting for that royalty. ABC will recognize the milestone payment only once the underlying sales threshold has been met.

Example F360.2

Milestone payments linked to sales- or usage-based amounts and other items

Assume the same facts as in Example F360.1, except that the $10 million milestone payment is payable only after both (1) Customer has reached sales of $100 million of Product X that includes ABC's software *and* (2) ABC has successfully modified its software for use in Customer's new technology product (Product Z).

In this example, even though the milestone payment depends partially on Customer's subsequent sales of ABC's software (sales of ABC's software included in Product X), the milestone payment is not a sales-based royalty because the payment also depends on factors other than subsequent sales of ABC's software by Customer (successful modification of ABC's software for an additional use).

Consequently, the milestone payment is subject to the general guidance on variable consideration (including the constraint on variable consideration), which means any amount of such payment that is included in the transaction price at the point in time the software license is transferred to Customer will be recognized as revenue at that time.

Question F370

If a sales- or usage-based royalty relates to more than one license and other goods and services, does the royalties recognition constraint apply if no single license is predominant?

Interpretive response: It depends. The Basis for Conclusions to ASU 2016-10 (BC75) states that if, together, two or more of the licenses to which the royalty relates are predominant – i.e. the royalty relates predominantly to those multiple licenses when considered in aggregate – the royalties recognition constraint applies to that royalty.

Excerpt from ASU 2016-10

BC75. To enhance understandability and promote consistency in application, the Board decided to clarify that:

a. An entity should not account for a single royalty under two constraint models. That is, the entity should not split a single royalty between a portion to which the royalties recognition constraint would apply and a portion to which the general constraint on variable consideration (in paragraphs 606-10-32-11 through 32-13) would apply. However, this amendment does not affect the requirement to allocate fees due from a sales-based or usage-based royalty to the performance obligations (or distinct goods or services) in the contract to which the royalty relates, regardless of the constraint model the entity is required to apply (see Example 35, Case B and Example 60 in Topic 606, which demonstrate that application of the royalties recognition constraint does not change the requirement to allocate the transaction price to the performance obligations in the contract).

b. A sales-based or usage-based royalty is promised in exchange for a license and, therefore, the royalties recognition constraint applies whenever a license is the sole or predominant item to which the royalty relates. This would include situations in which no single license is the predominant item to which the royalty relates but the royalty predominantly relates to two or more licenses promised in the contract.

Question F380

Is a promise to provide future updates, upgrades and enhancements a license of IP for purposes of determining the applicability of the royalties recognition constraint?

Interpretive response: Whether specified or unspecified, a promise to provide updates, upgrades and enhancements (as well as rights to use specified or unspecified additional software products) is fundamentally a promise to provide the customer with a right to use updated, upgraded or enhanced IP. Therefore, when considering whether a sales- or usage-based royalty relates predominantly to one or more (see Question F370) licenses of IP, we believe rights to specified or unspecified updates, upgrades or enhancements (as well as rights to use specified or unspecified additional software products) should be considered licenses of IP.

Question F385

Can the royalty exception apply when a software license is not distinct from other goods or services?

Interpretive response: Yes, but only if the license is considered the predominant item to which the royalty relates. As stated in the basis for conclusions to ASU 2016-10 (BC77), the FASB decided not to restrict the royalty exception to a license that is a separate performance obligation because of the usefulness of the information from applying the exception.

Generally, when a license is not distinct from other goods or services, the royalty exception applies when the nature of the promise is to ultimately transfer IP. For example, if software and customization services are combined, the nature of the promise may be that of modified IP and subsequent royalties would relate to sales or usage of the modified IP.

In contrast, when the nature of a combined promise is a supply of a tangible product with embedded IP, any subsequent royalties would generally not be predominantly related to the IP.

Question F390

Does a declining royalty rate that applies prospectively create a material right for the customer with respect to future sales or usage of a software license subject to the royalties recognition constraint?

Interpretive response: No. Some software licensing arrangements provide tiered pricing whereby a customer will pay a lower royalty rate later in the contract. For example, an arrangement may require the customer to pay $0.10 per usage during the first year of the contract or until a certain volume of usage has occurred and then $0.08 per usage thereafter. Some have questioned whether the higher initial rate creates a material right for the customer with respect to later usage of the software.

This type of pricing scheme does not provide the customer with a material right because, as outlined in Question C380, each subsequent sale or usage of the licensed software is not an 'optional purchase'. The nature of the entity's promise in granting a software license is to provide the customer with the right to use the entity's software. Once the customer controls its right to use the software (i.e. controls the license), the customer's subsequent use of that right does not involve the customer undertaking a decision to make an additional purchase from the entity, and therefore each subsequent sale or usage is not an optional purchase for which the customer can have a material right.

Therefore, in the example outlined, the entity would recognize the contractually owed royalty each time a subsequent usage occurs – i.e. the entity would recognize $0.10 in revenue per usage for as long as that is the enforceable amount owed per usage and would recognize $0.08 in revenue per usage after the customer reaches the defined threshold and $0.08 becomes the amount to which the entity is entitled for each usage.

Example F390.1

Declining royalties – Prospective basis

ABC Corp. enters into a five-year arrangement to license software to Customer. The software license provides the customer with a right to use ABC's software (see Questions F10 and F20). The consideration for the license is a sales-based royalty of Customer's gross sales to end customers of products that include ABC's software, structured as follows: Year 1: 10%, Year 2: 8%, Year 3: 6%, Year 4: 4%, Year 5: 2%. ABC is not required to refund or adjust the price for any portion of a royalty once it is earned.

ABC does not assume a weighted average royalty rate based on the expected sales and also does not consider whether the lower royalty rate in later years of the contract provides the customer with a material right – i.e. because each additional product sold using ABC's software is not an 'optional purchase' by Customer.

ABC recognizes revenue as the subsequent sales of products including ABC's software occur based on the royalty rate applied to that sale in the contract.

Question F400

Does a declining royalty rate that applies retrospectively preclude recognition of royalties when the customer's subsequent sales or usage occur?

Interpretive response: In some tiered-pricing structures, the customer will be granted a refund or credit related to royalties previously paid once the customer reaches a lower pricing tier. For example, an arrangement may require the customer to pay $0.10 per usage during the first year of the contract or until a certain volume of usage has occurred and then $0.08 per usage thereafter. In addition, the contract may require the entity to provide the customer with a rebate for the extra $0.02 it has paid per usage while it was still within the higher pricing tier.

In such cases, the entity will need to estimate the ultimate royalty rate that will apply to each subsequent sale or usage. The potential rebate is variable consideration (i.e. consideration payable to a customer) and, therefore, we believe the entity would be required to recognize only that portion of the per-usage fee to which it expects to be entitled. This means that, in the example above, if the entity expects to have to provide a rebate in the amount of $0.02 per usage for each usage it initially bills $0.10, the entity should *not* recognize $0.10 per usage. The entity should instead recognize only the amount of that $0.10 to which it ultimately expects to be entitled, which includes consideration of the general constraint on variable consideration with respect to that variability in the per-usage rate (price).

Example F400.1

Declining royalties – Retrospective basis

ABC Corp. enters into a five-year arrangement to license software to Customer. The software license provides the customer with a right to use ABC's software (see Questions F10 and F20). The consideration for the license is a sales-based royalty of Customer's gross sales to end customers of products that include ABC's software, structured as follows: First 10,000 product sales: 10%; product sales 10,001 – 20,000: 9%; product sales 20,001 – 30,000: 8%; 30,001 – 40,000: 7%; 40,001+: 6%. When Customer crosses into a new pricing tier, it receives a refund of the prior royalties it paid per unit (for all units) in excess of the rate applicable in the new pricing tier.

ABC estimates the number of units it expects Customer to sell that include its software. Using an expected value method (see paragraph 606-10-32-8), ABC estimates that Customer will sell 29,000 units. ABC further concludes that it is probable Customer will not sell any more than 33,000 units. If Customer were to sell 29,000 units it would be entitled to 8% of Customer's gross sales price for all of those 29,000 units. However, if Customer sells 33,000 units, Customer would be entitled to 7% of Customer's gross sales price for those 33,000 units.

ABC concludes that it should recognize 7% per Customer product sale until it becomes probable Customer will not sell at least 30,001 units. If, for example, at the end of Year 2, it becomes probable that Customer will not sell more than 30,000 units, ABC will recognize a cumulative effect adjustment to recognize previously deferred royalties to reflect that (a) it now expects to be entitled to 8% per Customer product sale and (b) use of that rate does not carry the risk of a significant revenue reversal.

Question F410

In an increasing royalty rate scenario, should the entity recognize revenue at its expected 'blended' rate?

Interpretive response: No. The royalties recognition constraint precludes recognition of royalty amounts before the customer's subsequent sales or usage occurs. Therefore, it would be inappropriate to recognize royalties at an anticipated higher 'blended' rate.

Example F410.1

Increasing royalty rate

ABC Corp. enters into a five-year arrangement to license software to Customer. The software license provides the customer with a right to use the ABC's software (see Questions F10 and F20). The consideration for the license is a sales-based royalty of 2% of Customer's gross sales to end customers of products that include ABC's software for the first 10,000 products sold; 4% for the next 10,000 products sold; and 5% for all products sold thereafter. ABC expects based on relevant, objective evidence that Customer will sell between 26,000 and 29,000 products that includes ABC's software. The lower initial royalty rate was agreed by ABC in order to permit Customer to sell its products initially at a lower price point to generate demand.

Despite the fact that ABC has relevant, objective evidence suggesting that, on a blended rate basis, it will be entitled to more than 2% per product sold, ABC does not estimate a blended rate to apply to the first 10,000 unit sales of Customer's product. ABC recognizes a royalty of 2% on each sale of a Customer product until 10,000 products are sold.

Question F420

How should a software entity attribute revenue from a sales- or usage-based royalty subject to the royalties constraint allocable to a performance obligation satisfied over time?

Interpretive response: A software entity may enter into a contract with a customer to grant the customer a software license and provide one or more other services (e.g. software-related services, such as PCS or hosting services) that are satisfied over time. If the only consideration in the contract is a sales- or usage-based royalty, the question arises as to how to apply the royalties constraint (paragraph 606-10-55-65) to the contract when the software license(s) is (are) the predominant item(s) to which that sales- or usage-based royalty relates.

Example 60 to Topic 606 (paragraphs 606-10-55-393 – 55-394) illustrates that Topic 606 requires the entity to allocate the sales- or usage-based royalty to the separate performance obligations in the contract. This allocation would occur based on the stand-alone selling prices of the performance obligations. Because the only consideration in the contract is the sales- or usage-based royalty, the entity would not be able to allocate the royalty entirely to only one or some of the performance obligations in the contract.

Assuming the software license is transferred to the customer before royalties are earned – i.e. the entity's performance in transferring control of the software license is complete before royalties are earned – the entity will recognize the portion of each royalty earned that is allocated to the software license when the customer's subsequent sale or usage occurs.

Recognition of the portion of each royalty allocated to a performance obligation satisfied over time will often, but not always, occur when the customer's subsequent sales or usage occur. This is because there are a number of pathways provided within Topic 606 that would result in recognition of royalties allocated to a service obligation that is satisfied over time. For example:

— If the allocated portion of the royalty reasonably reflects the value to the customer of the entity's performance to which the earned royalties relate, it would be reasonable to recognize the allocated portion of the royalty earned when the customer's subsequent sales or usage occur based on applying the measure of progress practical expedient in paragraph 606-10-55-18 (i.e. the 'as-invoiced' practical expedient). Questions F280 – F330 address considerations relevant to determining whether an entity can apply the 'as-invoiced' practical expedient.

— If the service obligation is a series of distinct services (e.g. most technical support, unspecified update/upgrade/enhancement and hosting service performance obligations will be series of distinct services), allocation of the service portion of the earned royalties to each distinct service period (e.g. each day or month that the service is being provided) may be permitted based on the guidance in paragraph 606-10-32-40. Question C140 discusses considerations for determining whether certain software-related service obligations constitute a series of distinct services. *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the* *contract* discusses the relevant considerations in determining whether a software entity should allocate variable consideration to the distinct goods or services within a series in accordance with paragraph 606-10-32-40.

— The Basis for Conclusions to ASU 2016-10 (BC71) highlights that the 'later of' provision in paragraph 606-10-55-65(b) that comes into play in scenarios such as the subject of this question "is merely intended to ensure that the royalties guidance does not subvert one of the key principles of Topic 606, which is to recognize revenue only when (or as) an entity satisfies a performance obligation." BC71 further elaborates that, "An entity recognizes revenue from a sales- or usage-based royalty when (or as) the customer's subsequent sales or usage occur unless recognition in that manner would accelerate the recognition of revenue for the performance obligation to which the royalty solely or partially relates ahead of the entity's performance toward complete satisfaction of the performance obligation based on an appropriate measure of progress." Example 57 (paragraphs 606-10-55-375 – 55-382) and Example 61 (paragraphs 606-10-55-395 – 55-399) each illustrate a scenario in which the entity recognizes a sales-based royalty that relates solely to a performance obligation satisfied over time when the customer's subsequent sales occur. Each example does so on the basis that "recognition of the royalty fees as the customer's subsequent sales occur reasonably depict the entity's progress toward complete satisfaction of the license performance obligation", rather than with reliance upon either the practical expedient in paragraph 606-10-55-18 or the variable consideration allocation guidance in paragraph 606-10-32-40. Therefore, even if neither of the approaches outlined in the preceding two bullets apply, recognition of the royalties allocated to the over-time performance obligation would still be recognized when the customer's subsequent sales or usage occur if the royalties are expected to become due in a manner that reasonably approximates an appropriate measure of progress for measuring satisfaction of the performance obligation in accordance with paragraph 606-10-25-31.

It may be the case in some circumstances, however, that none of the approaches above are appropriate. For example, this may occur because the royalty rate changes during the contract in a manner that does not reflect changing value to the customer of the entity's services (see paragraph BC71 in ASU 2016-10). In that case, we believe either of the two following approaches would be acceptable:

— The entity would be permitted to estimate total expected royalties that will be earned and allocated to the over-time performance obligation(s) in accordance with paragraphs 606-10-32-5 – 32-9. In this case, the entity would *not* subject that estimate to the constraint on variable consideration because, as outlined in paragraph BC71, the general constraint does not apply when the royalties recognition constraint applies. The entity would recognize revenue using an appropriate measure of progress applied against that estimate of earned and allocated royalties, adjusting the estimate each reporting period. By way of example, in a contract to provide a customer with a software license and a software-related service satisfied over time for which the only consideration is a sales- or usage-based royalty, the entity would estimate total royalties it will earn over the license period (e.g. $100,000), determine the portion of that amount allocable to the service (e.g. $20,000), and recognize that $20,000 over the service period using an appropriate measure of progress (subject to the requirement that cumulative revenue recognition for the service should never exceed 20% of royalties earned based on the customer's subsequent sales or usage).

— The portion of the royalty amount earned each period during which the over-time performance obligation will be satisfied (e.g. $2,000 in the first quarter of the software-related service period) should be recognized using an appropriate measure of progress over the remainder of the period the over-time performance obligation will be satisfied. For example, if $100 in royalties are earned and allocated to a software-related service on Day 1 of a three-year service period, that $100 will be recognized over the entire three-year service period; if $200 in royalties are earned and allocated to the software-related service on the first day of Year 2 of the three-year service period, that $200 will be recognized over the remaining two years of the service period. Under this approach, the entity would not estimate future royalties to be earned.

Example F420.1

Usage-based fees in a software licensing arrangement with PCS

ABC Corp. licenses transaction-processing software to financial institutions. ABC executes a three-year term license with Customer and also agrees to provide technical support and unspecified updates, upgrades and enhancements to the software for the full three-year term. ABC will receive only usage-based fees of $0.05 per transaction processed by the software – i.e. there are no other fees payable to ABC under the contract. There is no guaranteed minimum for the usage-based fees. Further:

— ABC concludes that the technical support and the unspecified updates, upgrades and enhancements are a single, stand-ready, PCS performance obligation (see Questions C130 and C150).

— ABC concludes that the software license and the PCS are distinct from each other (see Questions C160 and C170) and, therefore, the contract includes two performance obligations (the software license and PCS).

— The software is functional IP and provides Customer with a right to use ABC's software (see Questions F10 and Question F20). The three-year term commences immediately upon transfer to Customer of a copy of the software along with the necessary software key, which are both provided at contract inception. Therefore, Customer obtains control of the software license on the contract inception date.

— The PCS performance obligation constitutes a series of distinct PCS service periods (see Question C140).

ABC concludes that the royalties recognition constraint applies to the royalty (see overview discussion preceding Question F340, and Question F380). Therefore, despite the fact that ABC may be able to reasonably estimate a minimum amount of transaction-based fees to which it will be entitled from transferring the license to Customer (e.g. on the basis of similar licensing arrangements with other customers), ABC is prohibited from recognizing the transaction-based fees before Customer's usage takes place.

Because there are two separate performance obligations, ABC must determine the stand-alone selling prices for the license and the PCS and allocate the usage-based fees to those two performance obligations. In this example, assume the stand-alone selling prices of the license and the PCS are $200,000 and $120,000, respectively.

Therefore, each period when royalties are earned, 62.5% of those royalties are allocated to the software license that was transferred to the customer at contract inception and 37.5% of those royalties are allocated to the PCS.

The 62.5% portion allocated to the software license is recognized as revenue when the customer's usage occurs in accordance with paragraph 606-10-55-65(a) because the software license performance obligation is completely satisfied at contract inception.

The 37.5% portion of royalties earned each period that is allocated to the PCS is recognized as the customer's usage occurs. ABC concludes that:

— the 37.5% portion of the royalties earned specifically relates to ABC's provision of the PCS based on consideration of the terms of the contract and the stand-alone selling price of the PCS; and

— allocating those royalties to each distinct PCS period (e.g. each month or even each day) within the series of distinct service periods that comprise the PCS performance obligation is consistent with the transaction price allocation objective in paragraph 606-10-32-28. This is on the basis that (1) customers' with higher expected transaction volumes generally have a greater need for technical support; and (2) updates, upgrades and enhancements generally provide greater benefit to a customer using the software more extensively – e.g. an upgrade increasing processing speed will provide proportionally greater benefit to a customer processing 100,000 transactions per period than one processing only 10,000 transactions per period.

ABC further concludes that recognition of the allocated royalties when those royalties are earned is appropriate because, on the basis of relevant experience with similar arrangements, even though it expects transaction volumes to fluctuate throughout the license period, it does not expect total royalties that will be earned to be significantly front- or back-loaded. Therefore, recognition of allocated royalties as earned is unlikely to result in a recognition pattern that substantively accelerates revenue recognition for the PCS ahead of the entity's expected performance over the PCS period.

Question F430

Can a software entity apply the royalty exception when the royalty is calculated on a financial metric other than sales?

Interpretive response: It depends on whether the metric is considered 'sales-based'.

In certain software licenses, royalties are calculated based on financial statement metrics other than sales. For example, a software entity may be entitled to a fee based on a fixed percentage of gross profit generated by the customer for the term of the contract. The contract might define gross profit as net sales less costs of goods sold.

When the metric is 'sales-based', we believe the exception should be applied. Determining if the royalty exception is sales-based depends on whether the metric is directly attributable to revenue or sales volumes and how the customer uses the IP.

A metric such as gross profit, defined as sales less cost of goods sold, is generally directly attributable to revenue and sales volumes. To the extent cost of goods sold is clearly defined and its variability is predominantly based on revenue, an entity can apply the royalty exception.

However, the royalty exception may not apply if the royalty calculation includes other items such that a direct correlation to revenue no longer exists, or if it is based predominantly on something other than sales. Examples include calculations incorporating significant fixed costs (e.g. sales department compensation), other adjustments (e.g. decline in value of goods, obsolescence, damage), allocations between multiple goods or services that are not defined or applied consistently, and changes to inventory cost method used.

For other profit metrics (e.g. EBITDA, net income), entities should consider the degree to which the metric is affected by changes in sales versus allocations of other costs when determining whether use of the royalty exception is appropriate.

Question F440

How is the transaction price allocated in an arrangement that includes sales- or usage-based royalties subject to a guaranteed minimum?

Interpretive response: An entity may enter into a contract with multiple performance obligations that consist of a license of IP and another good or service that is transferred over a different time period. If requirements to allocate variable consideration entirely to one performance obligation are not met, an entity allocates the sales- or usage-based royalties to multiple performance obligations. The assessment can be particularly challenging when the contract includes fixed consideration, which can be in the form of a minimum guaranteed royalty.

Topic 606 is not clear about how an entity allocates that consideration to its performance obligations when the contract includes sales- or usage-based royalties predominantly associated with a license of IP and a guaranteed minimum. Multiple approaches could be acceptable if they are consistent with the allocation objective (see *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*) and application of the royalty exception. We believe the following are examples of acceptable approaches.

Approach 1: Allocate the fixed consideration and variable consideration separately based on relative stand-alone selling prices

Approach 1 is consistent with Example 35, Case B of Topic 606, which illustrates allocating royalties and fixed consideration to two distinct licenses. In that example, the entity allocates the fixed consideration to the performance obligations at contract inception on a relative stand-alone selling price basis and then allocates the royalties on a relative basis when the sales or usage occurs. The same relative allocation percentage is used for the fixed and variable consideration.

Approach 2: Estimate the total transaction price (including royalties) and allocate that amount to each performance obligation subject to a cumulative recognition constraint

Under Approach 2, the entity estimates an unconstrained transaction price (that includes estimated royalties and fixed consideration) and allocates that amount to each performance obligation on a relative stand-alone selling price basis. Further, under this approach the entity applies the royalty exception on a cumulative basis. This means that when an entity satisfies or partially satisfies a performance obligation, it recognizes the lesser of the amount allocated to the performance obligation and the consideration to which it is currently entitled under the contract (inclusive of the fixed fees and royalties that it has already earned).

Under Approach 2, an entity continuously updates its estimate of the total consideration to which it expects to be entitled. However, the entity does not apply the variable consideration constraint (see *Chapter D – Step 3: Determine the transaction price*). This is because the variable amounts are subject to the royalty exception rather than the variable consideration constraint. However, this approach could result in a reversal of revenue if the entity's estimates change significantly as a result of re-allocating the decrease in consideration to performance obligations that have been previously satisfied (see Example F440.2).

Regardless of the approach an entity uses, it needs to disclose significant judgments made in applying the guidance in Topic 606 regarding the determination and timing of revenue recognition. Moreover, it should apply the approach consistently to similar contracts.

Example F440.1

Allocation of guaranteed minimum among multiple performance obligations

Tech Company enters into a three-year arrangement to license its technology to Customer along with a promise to provide when-and-if-available upgrades developed during the license term.

Tech Company concludes that the license and promise to provide when-and-if-available upgrades are two distinct performance obligations.

— The license provides Customer with a right to use the technology, which is a performance obligation satisfied at a point in time.

— The right to when-and-if-available upgrades is a performance obligation satisfied over time because Customer simultaneously receives and consumes the benefits of having access to when-and-if-available upgrades continuously throughout the contract term.

Tech Company receives a royalty of 10% of Customer's sales subject to a minimum guaranteed amount of $10,000. Tech Company estimates that the total consideration (fixed plus variable) will be $50,000.

Tech Company estimates the stand-alone selling price of the license and when-and-if-available upgrades to be $15,000 and $35,000, respectively. Tech Company concludes that the royalty is predominantly associated with a license of IP because both performance obligations are related to providing IP (see Question F380).

Customer's gross sales and the related royalties earned each year are shown in the table. This information is not known at the beginning of the contract.

	Year 1	Year 2	Year 3	Total
Gross sales	$150,000	$250,000	$100,000	**$500,000**
Royalties	$ 15,000	$ 25,000	$10,000	**$ 50,000**

Approach 1: Allocate fixed and variable consideration separately

Tech Company allocates the fixed fee (guaranteed minimum) of $10,000 on a relative stand-alone selling price basis as future usage and sales occur.

Performance obligation	Stand-alone selling price	%	Allocation of guaranteed minimum
License	$15,000	30%	$ 3,000
Upgrades	$35,000	70%	$ 7,000
Total	**$50,000**	**100%**	**$10,000**

The estimated variable royalty (in excess of the minimum) of $40,000 is allocated between the two performance obligations on a relative stand-alone selling price basis as future usage and sales occur.

Tech Company recognizes the variable amounts allocated to the when-and-if-available upgrades in the period the amounts are earned because the performance obligation is a series of distinct time periods (see *Chapter C – Step 2: Identify the performance obligations in the contract*) and Tech Company meets the criteria to allocate the fees directly to the distinct periods in which the sales occur as follows:

- the fees relate to the customer's past usage and the license and when-and-if-available upgrades; and
- the allocation is consistent with the allocation objective because the fee is consistent from period to period and the greater usage of the customer reflects additional value to the customer (see *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*). [606-10-32-40]

The following table summarizes the allocation and recognition for each performance obligation during the three-year contract term.

	Inception	End of Year 1	End of Year 2	End of Year 3	Total
Fixed					
License	$3,000[1]	-	-	-	**$ 3,000**
Upgrades	-	$2,333[2]	$ 2,333[2]	$ 2,333[2]	**$ 7,000**
Variable					
License	-	$1,500[3]	$ 7,500[5]	$ 3,000[7]	**$12,000**
Upgrades	-	$3,500[4]	$17,500[6]	$ 7,000[8]	**$28,000**
Cumulative revenue					
License	$3,000	$4,500	$12,000	$15,000	**$15,000**
Upgrades	-	$5,833	$25,666	$35,000	**$35,000**

Notes:

1. $10,000 minimum × 30% allocation. This amount is recognized immediately upon transfer of the license because it is functional IP recognized at a point in time.
2. $10,000 minimum × 70% allocation × 1/3 complete. Only a portion is recognized each period because this amount is recognized over time.
3. $5,000 royalty above the minimum ($15,000 – $10,000) × 30% allocation.
4. $5,000 royalty above the minimum ($15,000 – $10,000) × 70% allocation.
5. $25,000 additional royalty × 30% allocation.
6. $25,000 additional royalty × 70% allocation.
7. $10,000 additional royalty × 30% allocation.
8. $10,000 additional royalty × 70% allocation.

Approach 2: Allocate fixed and variable consideration together

Tech Company allocates the $50,000 estimated transaction price on a relative stand-alone selling price basis as follows:

- $15,000 to the license; and
- $35,000 to the when-and-if-available upgrades.

When (or as) the performance obligations are satisfied, Tech Company recognizes as revenue the lesser of the amount allocated to the performance obligations satisfied or the amount that is no longer subject to the royalty constraint.

	Inception	Year 1	Year 2	Year 3	Total
Allocated to:					
License	$15,000[1]	-	-	-	**$15,000**
Upgrades	-	$11,667[3]	$11,667[3]	$11,667[3]	**$35,000**
Cumulative	*$15,000*	*$26,667*	*$38,333*	*$50,000*	n/a
Royalty due:					
Annual	$10,000[2]	$ 5,000[4]	$25,000[5]	$10,000[6]	**$40,000**
Cumulative	*$10,000*	*$15,000*	*$40,000*	*$50,000*	n/a
Lesser of amount allocated to satisfied PO and royalties due	$10,000	$15,000	$38,333	$50,000	n/a
Less: previously recognized revenue	-	($10,000)	($15,000)	($38,333)	n/a
Revenue recognized	**$10,000**	**$ 5,000**	**$ 23,333**	**$11,667**	**$50,000**

Notes:

1. The license is functional IP that is transferred at a point in time. As such, the performance obligation is satisfied upon transfer and the amount allocated to that performance obligation is $15,000.
2. There is a guaranteed minimum of $10,000 in the contract.
3. $35,000 allocated to the upgrades / 3 years.
4. $15,000 in royalties earned during Year 1 – $10,000 minimum already recorded.
5. $25,000 additional royalties earned during Year 2.
6. $10,000 additional royalties earned during Year 3.

Example F440.2

Allocation of guaranteed minimum among multiple performance obligations – revised estimates

Assume the same facts as in Example F440.1. At the beginning of Year 2, Tech Company revises its estimate of the transaction price to $25,000 as follows:

— Year 1 - $15,000
— Year 2 - $5,000
— Year 3 - $5,000.

Approach 1: Allocate fixed and variable consideration separately

Under Approach 1, Tech Company does not need to adjust the amount of revenue recognized because it only accounts for the variable consideration once usage occurs. The table illustrates the amount recognized under the revised estimate.

	Inception	End of Year 1	End of Year 2	End of Year 3	Total
Fixed					
License	$3,000	-	-	-	**$ 3,000**
Upgrades	-	$2,333	$ 2,333[1]	$ 2,333[1]	**$ 7,000**
Variable					
License	-	$1,500	$ 1,500[2]	$ 1,500[2]	**$ 4,500**
Upgrades	-	$3,500	$ 3,500[3]	$ 3,500[3]	**$10,500**
Cumulative Revenue					
License	$3,000	$4,500	$ 6,000	$ 7,500	**$ 7,500**
Upgrades	-	$5,833	$11,666	$17,500	**$17,500**

See Example F480.1 for an explanation of the figures at inception and at the end of Year 1.

Notes:

1. $10,000 minimum × 70% allocation × 1/3 complete. Only a portion is recognized each period because this is recognized over time.
2. $5,000 additional royalty × 30% allocation.
3. $5,000 additional royalty × 70% allocation.

Approach 2: Allocate fixed and variable consideration together

Under Approach 2, Tech Company makes a cumulative adjustment based on the updated estimate and reallocates the $25,000 estimated transaction price on a relative stand-alone selling price basis as follows:

— $7,500 (30%) to the license; and
— $17,500 (70%) to the upgrades.

	Inception	End of Year 1	True-up	End of Year 2	End of Year 3	Total
Allocated to:						
License	$15,000	-	$ (7,500)[1]	-	-	**$7,500**
Upgrades	-	$11,667	$ (5,833)[2]	$ 5,833[2]	$ 5,833[2]	**$17,500**
Cumulative	*$15,000*	*$26,667*	*$13,334*	*$19,167*	*$25,000*	n/a

	Inception	End of Year 1	True-up	End of Year 2	End of Year 3	Total
Royalty earned:						
Annual	$10,000	$ 5,000	-	$ 5,000[3]	$ 5,000[4]	**$25,000**
Cumulative	*$10,000*	*$15,000*	*$15,000*	*$20,000*	*$25,000*	n/a
Lesser of amount allocated to satisfied PO and royalties earned	$10,000	$15,000	$13,334	$19,167	$25,000	n/a
Less: previously recognized revenue	-	($10,000)	($15,000)	($13,333)	($19,167)	n/a
Revenue recognized	**$10,000**	**$ 5,000**	**($ 1,666)**	**$ 5,833**	**$ 5,833**	**$25,000**

See Example F480.1 for an explanation of the figures at inception and at the end of Year 1.

Notes:

1. The revised revenue allocation for the license is $7,500. As such, the amount already recognized is reduced to equal $7,500.
2. The revised revenue allocation for the upgrades is $17,500. As such, the amount already recognized is reduced to equal $5,833, and thereafter an additional $5,833 ($17,500 × 1/3) is recognized each year.
3. $5,000 additional royalties earned during Year 2.
4. $5,000 additional royalties earned during Year 3.

G. Contract modifications

Questions and Examples

Identifying a contract modification

Accounting for contract modifications

performance issues how should the entity account for that modification?

Example G80.1: Contract to purchase additional software licenses at a discount due to bugs

Example G80.2: Contract to extend SaaS arrangement that includes a discount for past performance issues

Q&A G90 How should an entity evaluate the criterion in paragraph 606-10-25-12(b) when the stand-alone selling price of the additional distinct good or service is highly variable or uncertain?

Example G90.1: Evaluating whether additional consideration reflects the stand-alone selling prices of added goods and services

Example G90.2: Evaluating whether additional consideration reflects the stand-alone selling prices of added goods and services that do not all have highly variable or uncertain stand-alone selling prices

Q&A G100 When a modification is accounted for prospectively in accordance with paragraph 606-10-25-13(a), is a contract asset that exists at the modification date written off?

Example G100.1: Contract asset in a modification accounted for prospectively as a termination of the original contract and the creation of a new contract

Q&A G110 How should an entity account for a modification that *decreases* the scope of a contract?

Example G110.1: Decrease in scope (and price) of PCS

Example G110.2: Partial termination of SaaS contract – no customer termination right

Example G110.3: Partial termination of SaaS contract that includes customer termination right subject to termination penalty

Q&A G120 How should an entity account for a contract modification that consists of a change in price only?

Example G120.1: Price decrease – SaaS arrangements

Example G120.2: Change in price in software customization contract

Q&A G130 What is the appropriate accounting for a modification that adds rights granted under a software license?

Q&A G131 What is the appropriate accounting for a modification that decreases rights granted under a software license?

Example G131.1: Contract modification revoking rights previously transferred

Q&A G132 What is the appropriate accounting for a modification granting the customer the right to convert a software license to SaaS?

Q&A G140 Can an entity recognize license revenue for a period that extends beyond the original license term before the beginning of the extended period if the entity and the customer terminate the original license and enter into a 'new' license that includes the remainder of the original term plus the extension period?

Example G140.1: Term software license terminated and new license with same rights entered into

Example G140.2: Term software license terminated and new rights of use granted

Q&A G150 How should an entity account for modifications that include some goods or services that are distinct from those provided pre-modification and some that are not distinct?

Example G150.1: Partially satisfied performance obligation and additional distinct goods or services (combination of methods)

Example G150.2: Partially satisfied performance obligation and additional distinct software license (combination of methods)

Q&A G160 In the case of an unpriced change order that has been determined to constitute a contract modification, is the expected payment that has not yet been approved variable consideration?

Example G160.1: Accounting for a contract modification resulting from an unpriced change order

This chapter is organized into distinct sections as follows:

— Identifying a contract modification
— Accounting for contract modifications

Identifying a contract modification

Overview

Excerpt from ASC 606-10

> Contract Modifications

25-10 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. In some industries and jurisdictions, a contract modification may be described as a change order, a variation, or an amendment. 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. A contract modification could 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 shall continue to apply the guidance in this Topic to the existing contract until the contract modification is approved.

25-11 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 shall 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 shall estimate the change to the **transaction price** arising from the modification in accordance with paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

A contract modification is a change in the scope or price of a contract, or both. This may in practice be described as a change order, a variation or an amendment, but however papered, the substance should be evaluated over form (e.g. see Question G140).

However, not all changes in price are contract modifications. The facts and circumstances causing the change in transaction price affects whether the pricing change is accounted for as a contract modification. The resolution of variability in the amount of expected consideration is accounted for as a change in transaction price (see *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract; Changes in the transaction price*) [606-10-32-42 – 32-45]

When a contract modification is approved, it changes the, or creates new, enforceable rights and obligations of the parties to the contract. Consistent with the determination of whether a contract exists in Step 1 of the model, this approval may be written, oral or implied by customary business practices, and should be enforceable under law.

If the parties have not approved a contract modification, then an entity continues to apply the requirements of Topic 606 to the existing contract until approval is obtained.

If the parties have approved a change in scope, but have not yet determined the corresponding change in price – i.e. an unpriced change order – then the entity estimates the change to the transaction price by applying the guidance on estimating variable consideration and constraining the transaction price.

The assessment of whether a contract modification exists focuses on whether the new or amended rights and obligations that arise under the modification are enforceable. This determination requires an entity to consider all relevant facts and circumstances, including the terms of the contract and applicable laws and regulations. We believe that an entity should assess whether it has the right to be compensated for satisfying the modified rights and obligations in the contract. This may require significant judgment in some jurisdictions or for some modifications – particularly if the parties to the contract have a dispute about the scope or the price. In cases of significant uncertainty about enforceability, written approval and/or legal representation may be required to support a conclusion that the parties to the contract have approved the modification.

The example below from Topic 606 illustrates the evaluation of an unapproved change in scope and price.

Excerpt from ASC 606-10

>>> Example 9 — Unapproved Change in Scope and Price

55-134 An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including force majeure) in the entity's access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.

55-135 The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights.

Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(b) by updating the transaction price and the measure of progress toward complete satisfaction of the performance obligation. The entity considers the constraint on estimates of variable consideration in paragraphs 606-10-32-11 through 32-13 when estimating the transaction price.

Questions & answers

Question G10

When is a contract modification approved?

Interpretive response: In general, determining that a modification has been approved is consistent with the determination made about whether a contract exists (see *Chapter B – Step 1: Identify the contract with the customer*). Approval occurs when the legally enforceable rights and obligations of a contract change. The assessment of whether a modification exists may require significant judgment in some jurisdictions or for some arrangements, particularly if the parties to the contract have a dispute about the scope or price. In cases of significant uncertainty about enforceability, written approval and/or legal representation may be required to support a conclusion that the parties to the contract have approved the modification.

When assessing the enforceability of the modifications and the contract existence criteria in paragraph 606-10-25-1 for of a contract modification, some additional, relevant considerations may include whether:

- the contractual terms and conditions are commensurate with the uncertainty, if any, about the customer or the entity performing in accordance with the modification (i.e. about the customer paying for or approving the modifications or about the entity being able to successfully fulfill its obligations);
- there is experience of the customer (or other similar customers) not fulfilling its obligations in similar modifications under similar circumstances; and/or
- the entity has previously chosen not to enforce its rights in similar modifications with the customer (or similar customers) under similar circumstances.

Question G20

If parties to a contract have agreed to a change in scope, but not the corresponding change in the transaction price, has there been a contract modification?

Interpretive response: Change orders are modifications of an original contract that effectively change the provisions of the contract. Some change orders are approved by the entity and customer on a timely basis, while others are not approved until later, perhaps even after completion of the project. Approval, whether related to the scope of the contract, the price or both, can occur in a variety of ways provided approval creates legally enforceable rights and obligations for both parties.

Unpriced change orders often occur where the parties agree on a change (or changes) to be made to the scope of a contract (e.g. changing the original features, functionality or configuration of licensed software), but the extent of effort necessary to effect the change is not known initially. In order to account for a contract modification that is an unpriced change order, both parties must have approved the change in the scope of the contract, and the entity must also (a) have an expectation that a change in price will be agreed to by the customer and (b) that the changed fees, once agreed, are probable of collection. The entity's expectation should be supported by evidence of the customer's commitment to fulfill its obligations under the contract (i.e. to pay for its goods and/or services). The entity's analysis with respect to its expectation that the price of the contract modification will be approved and that collectibility is probable should be consistent with how it evaluates (a) whether a customer is committed to perform under a contract and (b) whether collectibility of the transaction price is probable when identifying whether a contract exists (see *Chapter B – Step 1: Identify the contract with the customer*). However, we would generally expect collectibility will be less of a consideration given the existing contract and customer relationship (unless there has been a significant deterioration in the customer's credit standing, in which case it may be necessary to reassess whether there is still an existing contract with the customer).

In the Basis for Conclusions to ASU 2014-09 (BC39), the Boards clarified that their intention was not to preclude revenue recognition for unpriced change orders if the scope of the work has been approved and thus the entity has a right to payment for the additional work performed. The Boards affirmed that the consideration need not be fixed to identify the payment terms. An entity's expectation that the price of the modification will be approved could be based on a framework in the existing contract (e.g. master contract or other governing agreement), its historical experience with the customer and/or with similar contracts or its understanding of the law in the relevant jurisdiction. Topic 606 doesn't specify how an entity should arrive at that expectation, rather that it must have that expectation to conclude that an unpriced change order alters the parties' enforceable rights and obligations in the contract. Situation-specific facts and circumstances will often drive an entity's conclusion as to whether it can account for an unpriced change order as an approved contract modification, or whether it would wait until the change order is approved formally (e.g.

through a dually signed amendment). Therefore, an entity normally would need to develop processes and internal controls to support (1) its conclusions on the approval of the change in scope, (2) that there is a reasonable expectation of payment and (3) an estimated price for the change order in accordance with the variable consideration guidance.

Example G20.1
Assessing whether a contract modification is approved

ABC Corp. licenses trust asset management system software called Product B. Product B enables users, typically large financial institutions, to access and value individual US dollar denominated trust account portfolios on a real-time basis. Product B functions as designed without any customization or modification services and can be implemented without ABC's assistance in most cases.

ABC previously entered into a specific contract with Customer, a large bank, to grant a license to the Product B software and to provide services to modify the customer's instance of the software. This includes modification of the software code and configuration of certain modified and off-the-shelf settings to allow Customer to access and value its trust account portfolios in multiple foreign currencies in addition to US dollars. ABC expects that it will take approximately 18 months to perform the services.

Six months into performing the services, Customer informs ABC that it wishes to amend the scope of the services to create additional functionality within the software not previously contemplated in the initial contract, as well as to change some of the planned configurations of the software. ABC and Customer personnel discuss and agree to enact these changes and start preparing a formal amendment to the contract.

To determine whether to account for the contract modification at this point (i.e. before the amendment has been executed), ABC assesses whether a modification has been approved – i.e. whether communications between the parties have created new, or changed existing, enforceable rights and obligations under the contract.

In making this determination, ABC considers the following:

- Although ABC and Customer have not executed a contract amendment or formal change order for the change in specifications and the required time and resources necessary to complete the request, changes of this nature are common in similar contracts.
- ABC's experience in similar contracts is that when changes resulting from redesign have occurred, customers have compensated ABC for the incremental costs plus a margin, provided ABC has been able to demonstrate that the additional costs are reasonable given the scope of the changes.
- Despite the fact that there has been no formal written agreement on the change in scope or price, after consultation with its legal counsel, ABC

determines that there is legal precedent for enforceability of similar types of oral arrangements in the jurisdiction, thus changing the enforceable rights and obligations of the contract.

— The contract contains an 'out of scope' provision that establishes a framework under which work that is agreed to by the parties, but is beyond the original scope of the project, can be billed. Therefore, even though ABC expects it will negotiate a formal amendment with Customer that will establish fees for the change order, a framework exists for ABC to receive payment for such work that is approved even if a formal amendment is not concluded.

ABC therefore concludes that the contract modification has been approved.

Conversely, if the following facts and circumstances had existed, then ABC may have concluded that the contract modification had not yet been approved (not exhaustive):

— There was an absence of legal precedent in the jurisdiction related to oral understandings of this nature or ABC's counsel cannot make a determination as to the enforceability of the unpriced change order as a matter of law.

— ABC had limited history with similar software customization projects, such that it had no experience of successfully negotiating scope changes and collecting commensurate additional consideration.

— The contract did not include an 'out of scope' provision such that there was no framework, separate from executing an amendment to the contract, to determine how ABC might be paid for additional efforts undertaken as a result of the scope change.

— At the time of the scope change, it was not probable that Customer would be willing to pay any incremental fees resulting from the scope changes.

Comparison to legacy US GAAP

Under legacy US GAAP construction- and production-type 'contract accounting', which applied to software licensing arrangements that included the significant production, modification or customization of software and other circumstances where services were essential to the functionality of the licensed software, unpriced change orders were reflected in the accounting for a contract if recovery was probable. Some of the factors considered under legacy US GAAP when evaluating whether recovery was 'probable' included:

— the customer's written approval of the scope of the change order;
— separate documentation for change order costs that are identifiable and reasonable; and
— the entity's experience in negotiating change orders, especially as they relate to the specific type of contract and change orders being evaluated.

In contrast, outside of 'contract accounting' most entities generally did not account for a contract modification before they had persuasive evidence of an arrangement and the fees were fixed or determinable.

The contract modification guidance in Topic 606 differs from both the legacy US GAAP guidance that was applicable to long-term construction- and production-type contracts and the legacy US GAAP guidance applied to other software and SaaS arrangements. Consequently, the timing of revenue recognition associated with contract modifications may change. In particular, such timing may be accelerated as compared to legacy US GAAP for arrangements that were not subject to the long-term construction- and production-type contract guidance. This is because (1) the Topic 606 requirements around enforceability do not require approval of a change order to follow the entity's customary business practice for persuasive evidence of an arrangement and (2) the fees for a change order are not precluded from recognition before they are fixed or determinable based on the variable consideration guidance in Topic 606 – see *Chapter D – Step 3: Determine the transaction price*.

Question G30

If an arrangement that has already been determined to meet the Topic 606 contract existence criteria is subsequently modified, is an entity required to reassess whether the modified contract still meets the criteria to be considered a contract?

Interpretive response: In general, we believe the criteria in paragraph 606-10-25-1 would be assessed both (a) to determine that any new rights and obligations are enforceable and substantive, and (b) that any modifications to the existing rights and obligations do not render those existing rights and obligations unenforceable or non-substantive. With respect to (a), we believe it would be counter-intuitive to not evaluate *new* rights and obligations through the same lens as the original rights and obligations in the contract. Meanwhile, with respect to (b), we believe that a modification of a contract (i.e. assuming the modification is not a separate contract based on paragraph 606-10-25-12) would constitute a 'significant change in facts and circumstances' such that, in accordance with paragraph 606-10-25-5, the entity would reassess the contract existence criteria in paragraph 606-10-25-1 for the modified contract. That being said, we would typically expect an existing contract and customer relationship to affect the scrutiny an entity would have to apply in assessing the paragraph 606-10-25-1 criteria. For example, the entity's prior evaluation of credit-worthiness when assessing the original contract and the customer's timely payment of contract fees to date would likely influence the entity's evaluation as to whether the customer is committed to perform its obligations under the modified contract and whether collectibility is probable.

If a contract modification is determined to be a separate contract, we do not believe an entity would reassess the criteria in paragraph 606-10-25-1 with respect to the original contract.

Question G35

If the parties enter into a new contract at or near the same time as terminating the original contract, is the new contract a modification?

Interpretive response: Yes, if the substance is a change in the scope or price of the original contract. When an entity and customer change the scope or price of a contract, the change is accounted for as a modification regardless of its form. The form of that change in scope or price does not have to be papered as a modification of the existing contract. An entity could terminate a contract and enter into a new contract and achieve the same economic result as modifying an existing contract.

Consider the following examples that are structured differently but have the same economic outcome:

— Scenario 1. ABC Corp. enters into a contract to provide distinct monthly services to Customer for three years in exchange for $300 paid upfront. After the first year, ABC and Customer agree to amend the contract to add two additional years of service for an additional $600 paid at the date of the amendment; assume there is not a significant financing component in either the original agreement or the modified agreement. After the amendment, ABC will provide Customer with services for four more years and receive additional consideration of $600.

— Scenario 2. ABC enters into a contract to provide distinct monthly services to Customer for three years for $300 paid upfront. After the first year, ABC and Customer agree to terminate the original contract with no refund payable to Customer and enter into a separate four-year contract to provide the same services for $600 in additional consideration paid at the date the new contract is entered into; assume there is not a significant financing component in either the first or second contract. After the new contract is entered into, ABC will provide Customer with services for four more years and receive consideration of $600.

If entities were able to avoid the modification guidance by entering into separate contracts, the timing of revenue recognized could be significantly different for economically equivalent arrangements. For example, if the scenarios above are accounted for according to the form rather than the substance, the accounting would be as follows; assume ABC is using a time-elapsed measure of progress and has a contract liability of $200 at the end of the first year.

— Scenario 1 would be accounted for as a modification. The modification would be accounted for on a prospective basis and ABC would not reverse the contract liability. ABC would recognize $200 over each of the remaining four years (($600 additional consideration + $200 contract liability) / 4).

— Scenario 2 would require accounting for the termination of the original contract and the new contract separately. ABC would account for the termination of the original contract by recognizing the contract liability into revenue and then accounting for the new contract separately by recognizing the $600 over the four years of service. ABC would recognize a $350 ($200 reversal plus $150 of the new contract) in the first year of the new contract and $150 in the last three years.

To evaluate whether the substance of a new contract is a change in scope or price of a terminated contract, we believe the contract combination guidance in Step 1 needs to be evaluated to determine if the new and terminated contract are in substance a single modified contract. We believe this is appropriate because the change in price and scope of the terminated contract (i.e. the termination) occurs at or near the same time the new contract is entered into. That is, we believe the date the terms of one contract change and the date the new contract is entered into are relevant to the contract combination guidance rather than the date the terminated contract was originally entered into. After that determination, the modification guidance is applied to determine the appropriate accounting.

Similarly, we believe that when a contract is modified (including terminations) an entity needs to consider the contract combination guidance to determine whether other contracts entered into at or near the same time as the modification should be combined with the modification. This ensures that the modification is accounted for according to its substance and not its form.

The contract combination guidance requires that contracts entered into at or near the same time with the customer should be combined when:

— the contracts are negotiated as a package with a single commercial objective;

— the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or

— the goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation (see *Chapter B – Step 1: Identify the contract with the customer; Combining contracts*). [606-10-25-9]

Question G40

Is the exercise of a customer option for additional goods or services (including a renewal) that is considered a marketing offer, and not a material right, a modification of the existing contract?

Interpretive response: No. At the March 2015 TRG meeting, the TRG generally agreed that an entity could account for the exercise of an option *that grants the customer a material right* either:

— as a continuation of the current contract by allocating the additional consideration to the goods or services underlying the option; or
— as a contract modification.

A customer option that is considered a marketing offer is not the same as one that provides the customer with a material right; and therefore, we do not view the TRG discussion as analogous to this circumstance. In general, we believe a customer option that is a marketing offer (i.e. does not provide the customer with a material right) is not a part of the original contract and should be treated as a new contract upon exercising the option.

Further, even if the option price is lower than the exercise date stand-alone selling price (i.e. the stand-alone selling price of the optional good or service has increased since the option was granted), the entity would not adjust the accounting for the original contract (i.e. account for the option exercise as a modification of the original contract) or another existing contract. The exercise of the option would still constitute a new contract. Because the option price at the time of grant was commensurate with stand-alone selling price, even if the stand-alone selling price of the good or service has increased from when the option was granted, the exercise of the previously negotiated option that did not convey a material right to the customer – i.e. the purchase of the optional good or service subject to terms agreed previously – is not a modification changing the scope or the price of the original contract or another existing contract.

Question G50

When does a contract claim result in a contract modification?

Interpretive response: Contract claims are evaluated using the guidance on contract modifications. A contract claim is typically described as an amount in excess of the agreed contract price that a contractor seeks to collect from customers or other parties. Claims may arise from customer-caused delays, errors in specifications or design, contract terminations, change orders that are in dispute or unapproved on both scope and price, or other causes of unanticipated additional costs.

Assessing whether a claim gives rise to a contract modification may require a detailed understanding of the entity's legal position, which may require third-party advice, even when a master services agreement or other governing document prescribes the claim resolution process under the contract.

The assessment may be more straightforward if an objective framework for resolution exists – e.g. if the contract includes a defined list of cost overruns that will be eligible for reimbursement and a price list or rate schedule. Conversely, the mere presence of a resolution framework – e.g. a requirement to enter into binding arbitration instead of litigation – will generally not negate an entity's need to obtain legal advice to determine whether its claim is enforceable. If enforceable rights do not exist for a contract claim, then a contract modification has not occurred and no additional contract revenue is recognized until either approval or legal enforceability is established.

An entity's accounting for any costs incurred before approval of a contract modification will depend on the nature of the costs. In some circumstances, those costs will be expensed as they are incurred. In other circumstances, an entity will need to consider whether the expectation of costs without a corresponding increase in the transaction price requires the recognition of an onerous contract provision. Or, a contract modification may be considered a specifically anticipated contract such that the costs incurred before approval of the contract modification – i.e. pre-contract costs – would be capitalized if the fulfillment cost criteria in paragraph 340-40-25-5 are met, which *may* be the case if the costs relate to fulfilling goods or services that are distinct from those in the original contract.

Comparison to legacy US GAAP

Under legacy US GAAP construction- and production-type 'contract accounting', which applied to software licensing arrangements that included the significant production, modification or customization of software and other circumstances where services were essential to the functionality of the licensed software, a claim was included in contract revenues if it was probable that the claim would result in additional contract revenue that could be reliably estimated. This requirement was satisfied when all of the following conditions existed:

a. the contract or other evidence provided a legal basis for the claim; or a legal opinion had been obtained;
b. additional costs were caused by circumstances that were unforeseen at the contract date and were not the result of deficiencies in the contractor's performance;
c. costs associated with the claim were identifiable or otherwise determinable; and
d. the evidence supporting the claim was objective and verifiable.

In contrast, outside of 'contract accounting' most entities generally did not account for a claim as a contract modification before they had persuasive evidence of an arrangement for the modified contract and the resulting fees were fixed or determinable.

The contract modification guidance in Topic 606 requires an entity to assess whether the modification creates new, or changes, enforceable rights and obligations. Similar to legacy US GAAP, this assessment includes an evaluation of the collectibility of the consideration for an unpriced change order or claim. However, a number of additional criteria included in Topic 606 also need to be considered when evaluating whether a contract modification exists. These criteria may or may not have been incorporated into an entity's evaluation of the probability of recovery under legacy US GAAP, and may therefore change the timing of revenue associated with contract modifications. For example, when determining whether and when to recognize revenue from contract claims, an entity should consider whether there are differences between having a legal basis for a claim and the modification being legally enforceable. Enforceability would typically suggest that there needs to be a basis to conclude that the entity would prevail in legal proceedings rather than just having a legal basis for the claim itself.

Consistent with the comparison to legacy US GAAP in Question G20, recognition of claims-related revenue may be accelerated as compared to legacy US GAAP for arrangements that were not subject to the long-term construction- and production-type contract guidance because (1) the Topic 606 requirements around enforceability do not require approval of a change to follow the entity's customary business practice for persuasive evidence of an arrangement and (2) the fees for a change order are not precluded from recognition before they are fixed or determinable based on the variable consideration guidance in Topic 606 – see *Chapter D – Step 3: Determine the transaction price*.

Accounting for contract modifications

Overview

Excerpt from ASC 606-10

> Contract Modifications

25-12 An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

a. The scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 606-10-25-18 through 25-22).
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 any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

25-13 If a contract modification is not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall 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:

a. An entity shall account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. 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 identified in accordance with paragraph 606-10-25-14(b)) is the sum of:
    1. 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
    2. The consideration promised as part of the contract modification.

b. An entity shall account for the contract modification as if it were a part of the existing contract 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 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).
c. If the remaining goods or services are a combination of items (a) and (b), then the entity shall 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 this paragraph.

Having determined that a contract has been modified, an entity then determines the appropriate accounting for the modification. The Boards developed different approaches to account for different types of modifications with an overall objective to faithfully depict the rights and obligations arising from a modified contract. Certain contract modifications are treated as separate contracts, and others are accounted for as part of the existing contract. Topic 606 requires an entity to account for modifications on a prospective basis (when the additional goods or services are distinct), on a cumulative catch-up basis (when the additional goods or services are not distinct), or as a combination of the two approaches (i.e. both distinct and non-distinct goods or services are added to the contract).

A contract modification is treated as a separate contract (prospective treatment) if the modification results in:

— a promise to deliver additional goods or services that are distinct; and
— an increase in the price of the contract by an amount of consideration that reflects the entity's stand-alone selling price of those goods or services adjusted to reflect the circumstances of the contract.

When a contract modification meets the above criteria, there is no economic difference between an entity entering into a separate contract for additional goods or services or modifying an existing contract. That is because the stand-alone selling price is the price at which an entity would sell a good or service separately to a customer and there would be no discount to allocate between the two contracts. Therefore, the original contract continues to be accounted for as it was before the modification and the modification is treated as a new contract to which Topic 606 is applied.

If the modification does not result in the creation of a separate contract, then the entity's accounting for the modification is based on whether the remaining goods or services under the modified contract are distinct from those goods or services transferred to the customer before the modification.

If the remaining goods or services are distinct (but the pricing of the modification is not commensurate with the stand-alone selling price of those goods or services after reflecting the circumstances of the contract), then the entity accounts for the modification prospectively. This is because accounting for those modifications on a cumulative catch-up basis could be complex and may not necessarily faithfully depict the economics of a modification because the modification is negotiated after the original contract and is based on new facts and circumstances. This approach avoids opening up the accounting for previously satisfied performance obligations and reversals to previously recognized amounts. [ASU 2014-09.BC78]

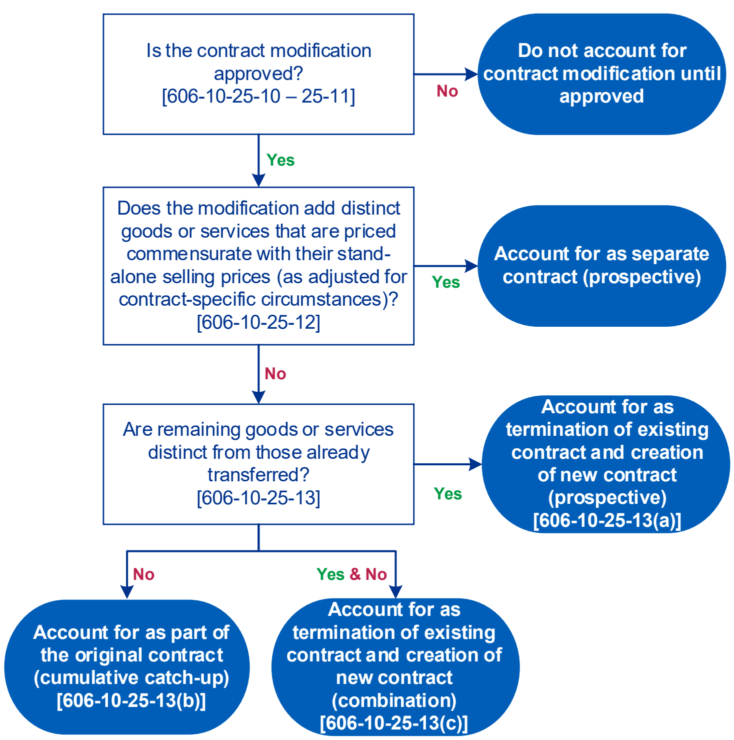
When the remaining goods or services are distinct, the entity accounts for the modification as if it were a termination of the existing contract and the creation of a new contract. In this case, the entity does not reallocate the change in the transaction price to performance obligations that are completely or partially satisfied on or before the date of the contract modification. Instead, the amount of consideration allocated to the remaining performance obligations is equal to:

— the consideration included in the estimate of the transaction price of the original contract that has not been recognized as revenue (which therefore excludes the amount of any contract asset existing at the modification date – see Question G100); plus or minus

— the increase or decrease in the consideration promised by the contract modification.

If the modification does not add distinct goods or services, then the entity accounts for it on a combined basis with the original contract, as if the additional goods or services were part of the initial contract – i.e. a cumulative catch-up adjustment. The modification is recognized as either an increase in, or reduction of, revenue at the date of the modification.

The key decision points to consider when determining whether a contract modification should be accounted for as part of the original contract or a separate contract are illustrated in the flow chart below.



Modifications to distinct goods or services in a series are accounted for prospectively

Identifying a performance obligation as a series of distinct service periods (e.g. SaaS, PCS and hosting services performance obligations will generally be considered a series of distinct SaaS, PCS or hosting service periods – see *Chapter C – Step 2: Identify the performance* obligations *in the contract*) can significantly affect the accounting for contract modifications. The Boards observed that modifications to a single performance obligation made up of a series of distinct goods or services should be accounted for prospectively. When a contract modification does not result in a separate contract, entities are required to evaluate whether the remaining goods or services are distinct even if those distinct goods or services are part of a single performance obligation. When the remaining goods or services are a part of a single performance obligation that is considered a series of distinct goods or services, the remaining items in that performance obligation will be considered distinct. [ASU 2014-09.BC79]

A distinct software license is *not* a series of, for example, distinct periods of access to that software. Rather a distinct software license is a *single* good transferred at a point in time.

The following table summarizes the contract modifications model under Topic 606; the questions that follow in this section provide additional detail and examples.

	Account for the contract modification as …		
	… a separate contract	… a termination of an existing contract and creation of a new contract	… part of the original contract
Example 1	Addition of one or more distinct goods or services (e.g. an additional software license and related PCS that are distinct from existing software licenses transferred to the customer and PCS being provided) at a price that reflects either (1) the stand-alone selling price for that (those) additional good(s) or service(s) or (2) a discount from stand-alone selling price resulting from adjustments that appropriately reflect the circumstances of the particular contract – see Questions G70 and G90 and Illustrative Example G1	Addition of one or more distinct goods or services at a price that is discounted from stand-alone selling price and that discount does *not* result from appropriate contract-specific adjustments; all remaining services provided under the original contract are also distinct – see Question G100	Addition of one or more goods or services that are not distinct from (i.e. becomes part of) a performance obligation in the original contract (e.g. incorporating an additional customization into a software customization project)

	Account for the contract modification as …		
	… a separate contract	… a termination of an existing contract and creation of a new contract	… part of the original contract
Example 2		Modification of the contract price, with no change in the contracted goods or services and the remaining goods and services are distinct from those already delivered (e.g. a price reduction in the monthly fees for the remaining months of a long-term SaaS or hosting services contract) – see Question G120	Modification of the contract price, with no change in the contracted goods or services *and* the remaining goods and services are not distinct from those already delivered (e.g. a change in the price of a software customization contract) – see Question G120
	Account for the contract modification as …		
	… a separate contract	… a termination of an existing contract and creation of a new contract	*…combination of methods*
Example 3		Decreasing the goods or services to be provided under the contract (e.g. shortening a SaaS, PCS or hosting services term) and the remaining goods or services are distinct from those already provided (e.g. a service obligation constitutes a series of distinct service periods such that the remaining service periods are distinct from the services provided before the modification) – see Question G110	Adding one or more distinct goods or services *and* changing the scope of a single performance obligation in the original contract (e.g. changing the specifications for a series of software customizations or the scope of a consulting report to be issued) – see Question G150
	Account for the contract modification as …		
		A scope decrease modification will never be accounted for as a separate contract (i.e. in accordance with paragraph 606-10-25-12)	

Illustrative example G1

Contract modification that is a separate contract

ABC Corp. sells Customer a three-year license to software Product A along with technical support and rights to unspecified updates, upgrades and enhancements (collectively, PCS – accounted for as a single performance obligation, see Question C150) beginning on January 1, 20X6. The consideration for the software license is $300,000. Consideration for the PCS over the license term is $162,000. ABC concludes that the PCS and the Product A license are priced commensurate with their stand-alone selling prices.

The terms of the license permit Customer to have 10 named users during the three-year license term. ABC makes available to Customer a copy of the software, and Customer's rights to use the software commence on January 1, 20X6.

ABC concludes that the software license and the PCS are distinct from each other. Consequently, ABC concludes that there are two performance obligations in this contract: the software license and PCS.

After the entity transfers control of the license to the customer on January 1, 20X6, there are no additional license rights to be transferred – e.g. there are no remaining promises for ABC to transfer additional rights to use the software in other geographies or for additional uses, or to grant additional named users. In other words, the customer controls all of the rights to use ABC's software that it will ever control under the contract as of that date.

On January 1, 20X7, ABC and Customer approve a contract modification. Under the modification Customer is permitted 20 named users (an increase from the original 10 named users permitted as of January 1, 20X6) for an additional fee of $200,000 for the remainder of the two-year contract term. The modification also includes additional PCS for the added users for an additional fee of $72,000. The additional named user rights represent an additional license (i.e. an additional good) ABC promises to transfer to Customer, while the incremental PCS represents an additional service ABC will provide.

ABC concludes that the additional 10-named user license to Product A and the incremental PCS, as a bundle, are distinct from (1) the original Product A license transferred on January 1, 20X6; (2) the PCS provided to Customer before the contract modification related to the original license; and (3) the remaining original license PCS yet to be provided under the original contract (i.e. two remaining years of such services) and therefore the criterion in paragraph 606-10-25-12(a) is met.

ABC further concludes that the additional consideration promised for the added license and incremental PCS reflects the stand-alone selling prices for those items and any appropriate adjustments to those stand-alone selling prices for the circumstances of this contract and therefore the criterion in paragraph 606-10-25-12(b) is met. In reaching this conclusion, ABC notes that the incremental consideration of $272,000 for the two-year license and two years of PCS is directly proportional to the $462,000 price for the original three-year license and three years of PCS – i.e. the license fee for the additional license is two-thirds of the price paid for the three-year original license that granted the same rights and the PCS fees in both cases are 18% of the license fee per year.

Question G90 discusses considerations for circumstances where a software license or a software license/PCS bundle has a highly variable or uncertain stand-alone selling price.

Because both criteria in paragraph 606-10-25-12 are met, ABC accounts for the modification granting the additional license and providing incremental PCS as a separate contract – i.e. separate from the original contract. Therefore, ABC's accounting for the original contract is unaffected by the modification.

Question G60

When evaluating whether contract consideration for additional, distinct goods or services reflects the stand-alone selling price of those goods or services, should an entity use the stand-alone selling price at the modification date or at the original contract's inception?

Interpretive response: At the time of the modification. The Basis for Conclusions to ASU 2014-09 (BC77) states that the objective of determining whether a contract modification should be accounted for as a separate contract is to determine whether there would be no economic difference between amending the current contract or entering into a new contract. As a result, the relevant stand-alone selling price is the price at the modification date, as if the modification were a new contract between the entity and a similarly situated customer with whom the entity does not have an existing contract.

Below is an example from Topic 606 that illustrates when the evaluation is made:

Excerpt from ASC 606-10

>>> Example 5 — Modification of a Contract for Goods

55-111 An entity promises to sell 120 products to a customer for $12,000 ($100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

>>>> Case A — Additional Products for a Price That Reflects the Standalone Selling Price

55-112 When the contract is modified, the price of the contract modification for the additional 30 products is an additional $2,850 or $95 per product. The pricing for the additional products reflects the standalone selling price of the products at the time of the contract modification, and the additional products are distinct (in accordance with paragraph 606-10-25-19) from the original products.

55-113 In accordance with paragraph 606-10-25-12, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract. The entity recognizes revenue of $100 per product for the 120 products in the original contract and $95 per product for the 30 products in the new contract.

Question G70

What evidence is required to substantiate that a deviation from stand-alone selling price reflects an 'appropriate adjustment' for the circumstances of a particular contract?

Interpretive response: Consider a scenario in which an entity enters into a contract with a customer for a distinct good or service before completing a previously contracted service, and the original contract and the new contract are not combined based on the guidance in paragraph 606-10-25-9 (see *Chapter B – Step 1: Identify the contract with the customer*). For example, assume an entity and a customer contract for a renewal of their existing three-year SaaS arrangement with six-nine months remaining of the original three-year SaaS term. Further consider that the price for the three-year renewal is below the pricing in the original contract and that the three-year renewal SaaS is distinct from the original three-year SaaS. This type of contract could be structured as an amendment to an existing contract or as a separate contract.

Because, in this scenario, the new contract is for a distinct good or service (in the example, distinct SaaS), the determination about whether the new contract is a modification of the original contract or, instead, a separate contract rests on (1) whether the additional consideration in the new contract reflects the stand-alone selling price of the distinct good or service and (2) if not, whether the deviation from stand-alone selling price reflects adjustments appropriate to the circumstances of the contract.

Step 1: Determine the appropriate stand-alone selling price

The stand-alone selling price for a good or service may differ for different classes of customer (e.g. new customers versus renewing customers, customers with licenses to many of the entity's products or services versus those with only a few or one). Therefore, it is important, when evaluating whether the additional consideration in a new contract reflects stand-alone selling price for the additional goods or services, to determine the appropriate stand-alone selling price for those goods or services. If an entity is frequently concluding that its sales to existing customers are below stand-alone selling price, the entity should first consider whether existing customers are a different class of customer than new customers such that the stand-alone selling prices of its goods or services are different for that class of customer.

The price at which an entity 'would sell a promised good or service separately to a [renewal or existing] customer' may be lower than the price at which an entity 'would sell a promised good or service separately to a [new] customer' because, as indicated in paragraph 606-10-25-12(b), 'it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.' While the absence of, or lower, selling costs (e.g. the entity may pay proportionally lower sales commissions on renewal contracts) may frequently be a reason for a lower renewal or existing customer stand-alone selling price, other costs also may be significantly lower (or not incurred at all) for renewal or existing customers. For example, SaaS providers may incur significant set-up costs for a new customer that it does not recover through set-up or implementation services fees. The same may be true for software licensing entities that provide hosting services. It also may be the case that a new customer requires significantly more technical support from the entity to acclimate to the new SaaS or software solution during an initial term than it will in renewal periods.

In addition to lower costs the entity may incur to obtain or fulfill a contract with an existing customer, a customer may migrate to a different class of customer through the modification. For example, a customer with an existing license capacity of 1,000 MIPS may add an additional 1,000 MIPS capacity (along with incremental PCS). The stand-alone selling price of a 1,000 MIPS license to a customer that will now be a 2,000 MIPS capacity customer (including related PCS) may be lower than the stand-alone selling price of a 1,000 MIPS license to a new customer.

Step 2: Determine if a deviation from stand-alone selling price is 'appropriate' to the circumstances of the particular contract

In certain circumstances, an entity may agree to sell an additional good or service to a customer at a price below the stand-alone selling price for those additional goods or services to that class of customer. In principle, we believe that in order for a deviation from the stand-alone selling price to be an adjustment 'appropriate' to the circumstances of the particular contract (and therefore, not result in a modification to the original contract), it must result from a negotiation between the entity and the customer that is separate from the original contract and unrelated to the original contract. That is, the terms and conditions of the new contract, including the adjustment from stand-alone selling price, must be unrelated to the entity's performance under, contract disputes arising from, or the pricing or payment terms of the original contract. This is consistent with the objective of determining whether a contract modification should be accounted for as a separate contract, expressed in the Basis for Conclusions to ASU 2014-09 (BC77), which is to determine when there is no substantive economic difference between modifying the existing contract and entering into a separate contract.

Judgment will frequently be required in evaluating whether a deviation from stand-alone selling price reflects an 'appropriate adjustment' based on particular contract circumstances, or instead, suggests that the new contract (however written – i.e. as an amendment, addendum or as a new contract) is modifying the terms and conditions of an existing contract. Specific facts and circumstances will need to be considered.

Assuming the new contract and the original contract are not combined in accordance with paragraph 606-10-25-9, we believe the following are factors that would provide relevant evidence about whether the new contract negotiation between the entity and the customer, resulting in the adjustment to (i.e. the discount from) the stand-alone selling price, is separate from the original contract (not exhaustive):

— **Competitive negotiation process.** If the customer was actively seeking bids from, or was being solicited by, other vendors for the same or similar goods or services, that may support a view that the deviation from stand-alone selling price in the new contract was the result of a substantive negotiation unrelated to the original contract, and the entity had a valid business reason unrelated to the prior contract for offering the discounted price. Additional evidence that suitable alternatives are being offered by other vendors at prices broadly consistent with the price in the new contract would support that the pricing in the new contract was the result of a substantive negotiation separate from any prior or existing contract.

— **Evidence of performance issues or payment disputes.** There may have been performance issues on the part of the entity (e.g. poor service or significant operating down-time) or customer payment disputes (e.g. the customer disputing amounts invoiced for services provided under the original contract, including disputes related to the measurement of variable consideration such as whether a performance bonus was or was not earned or service level penalties were or were not incurred) arising from the original contract. Such performance issues or payment disputes would generally create a presumption that at least some portion of the deviation from stand-alone selling price is related to those performance issues or payment disputes, affecting the accounting for the original contract (see Question G80). Conversely, the absence of any such issues would support, though would generally not be determinative, that the negotiation between the entity and the customer that resulted in additional consideration below the stand-alone selling prices of the additional goods or services is separate from the original contract.

— **History of price or other concessions.** A history of granting concessions to its customers would significantly elevate the burden of proof on an entity to substantiate that selling a distinct good or service at a price below its stand-alone selling price was for a valid business reason unconnected to the original contract. In such cases, the burden of evidence would increase to demonstrate that the discount from stand-alone selling price was for a business reason unrelated to the original contract and substantiate that the discount was proportional to the reason.

— **Changes to the terms of the original contract.** If the new contract changes the price, scope or billing terms for the remaining goods or services in the original contract, that would typically indicate the new contract and the original contract were not separately negotiated. Rather, the new contract's terms were agreed to in contemplation of the changes to the original contract. In contrast, no changes to the original contract should not be viewed as determinative that the original contract has not been modified; such a conclusion will generally also rely on consideration of other factors.

— **Set-up or other costs.** As outlined earlier in this question, the absence of, or lower, costs (e.g. to obtain or fulfill the contract) may suggest a reason for a lower stand-alone selling price for renewal or existing customers. However, contract-specific cost considerations may also exist that resulted in the entity selling an additional good or service at a discount from the stand-alone selling price for that class of customer. For example, if the customer has a sophisticated IT department that is able to perform necessary SaaS set-up activities rather than the entity's personnel, who typically undertake those activities for similar customers, that may justify a correspondingly lower contract price for the SaaS.

The following additional factors may also provide corroborative evidence that the new contract was negotiated without consideration to the original contract, depending on the facts and circumstances:

— **Period of time between original and new contract inception.** The greater the period of time between original and new contract inception and/or between the payment for the goods or services provided under the original contract and new contract inception, the more likely it may be that the terms and conditions of the new contract were negotiated separate from, and not affected by, the original contract.

— **Other observable prices.** The stand-alone selling price of the good or service may be based on a narrow range of observable prices. However, the entity may have a substantive number of stand-alone sales that are outside of that narrow range. When the price for the distinct good or service in the new contract is consistent with prices established in separately negotiated contracts, even if those prices are outside of the range used to establish stand-alone selling price, that may support that a discount from stand-alone selling price is unrelated to the original contract. That is, those other sales substantiate that the entity has sold the good or service at a similar price to other customers separate from prior contracts.

— **Customary business practices.** If the entity's process for negotiating and entering into the new contract with the customer is consistent with its customary business practice for entering into contracts with new customers (e.g. similar negotiation timeline, similar contract pricing guidelines for the entity's salespeople), that may be supportive of the new contract negotiation being unrelated to the original contract. For example, the fact that a SaaS provider is negotiating a renewal a few months *before* the end of the current contract term may be customary practice for the entity because customers need time to migrate to another solution if acceptable renewal terms cannot be agreed. The valid business reason for negotiating the renewal before the current term is complete supports that the timing of the negotiation is not indicative of any intent to modify the terms of the current contract.

Example G70.1

SaaS arrangement renewal accounted for as a separate contract

SaaS Company G enters into a contract with Customer to provide its SaaS for 3 years for a fee of $1,500 per month. The SaaS is a single performance obligation comprised of a series of distinct services. The contract does not include stated renewal options. With 6 months remaining in the contract, Company G and Customer enter into a new contract that extends the service for an additional three years at $1,300 per month. $1,300 is below the range Company G has established as the stand-alone selling price for the SaaS for this class of customer (i.e. similar customers entering into contract renewals). The remaining term of the original contract remains unchanged, and the entity will continue to charge $1,500 per month for the remaining six months.

In evaluating whether the new contract is a separate contract or a modification of the original contract, Company G first concludes that the new contract and the original contract would not be combined under paragraph 606-10-25-9 because they were not entered into at or near the same time (executed approximately 2.5 years apart).

Next, Company G concludes that the additional three-year SaaS is distinct from the original three-year SaaS obligation – i.e. the criterion in paragraph 606-10-25-12(a) is met. Customer can clearly benefit from each SaaS period separately; Company G can provide the SaaS for any period of time independent from providing it for any other period of time; and there is no integration, customization or modification of the SaaS services in one period with or by those provided in another period.

Lastly, Company G evaluates whether the discount from the stand-alone selling price for this class of customer represents an adjustment from stand-alone selling price that is unrelated to the original contract – i.e. the criterion in paragraph 606-10-25-12(b) is met. Company G's conclusion that the criterion in paragraph 606-10-25-12(b) is met is based on all of the following.

— While Company G is not aware of Customer soliciting bids from other SaaS or on-premise software providers, Company G understands Customer to be 'price-sensitive' and there are other readily available SaaS and on-premise solutions Customer could implement, including new entrants to the market since the original contract was executed, such that Company G operates in a competitive market. Company G has as a business objective to retain or enhance its market share even as the market becomes more competitive.

— Company G has no history of granting price or other concessions to its customers, and there have not been any significant service issues or payment disputes between Company G and Customer during the current contract term. For example, Customer has timely paid its invoices and there have not been disputes about service levels – i.e. Customer has not asserted that service level penalties have been incurred. Consequently, there is no evidence the discount from stand-alone selling price in the renewal contract is compensating the customer for past service issues/poor performance or represents a concession to settle an existing or prior payment dispute.

— During the initial three-year term, Customer has developed an internal, first-tier support capacity such that Customer's support needs from Company G have been, and are expected to remain, less than those of similar customers. Company G's support logs substantiate this and Company G considered this when deciding whether to accept the pricing Customer wanted for the renewal period.

— There are no changes to terms or conditions of the original contract resulting from the renewal contract (e.g. no changes to the scope of services that will be provided during the remainder of the original term, the payment terms or payment amounts).

— The negotiation and execution timeframe for the renewal contract, while occurring before the existing three-year SaaS period expires is for a valid business reason, which is that customers must have time to change solutions if the two parties cannot come to terms for a renewal. Therefore, the timing of the new contract negotiations occurring before the end of the existing contract period does not alone imply those negotiations included potential modifications to the remainder of the original contract.

Based on the facts and circumstances in this case, Company G concludes that the renewal contract with Customer is a separate contract (as described in paragraph 606-10-25-12), rather than a modification of the original contract. Consequently, the accounting for the original contract is not affected by the renewal.

Question G75

How should an entity account for a blend-and-extend modification?

Interpretive response: It depends. Entities sometimes enter into contract modifications whereby the period of a contract is extended in exchange for a new blended price throughout the remaining term. For example, after one year of a three-year contract priced at $100 per year, an entity and customer agree to extend the contract for two years and change the price for the remaining four years (original two remaining, plus two added) to $50.

In a typical blend-and-extend modification, the extension adds distinct goods or services (e.g. additional transactions to process or time increments that constitute a series). Therefore the modification would be accounted for as either a separate contract or the termination of an existing contract and the creation of a new contract (see *Chapter G – Contract modifications; Accounting for contract modifications*) depending on the price of distinct additional goods or services (assuming that a concession related to past performance is not included in the modification).

However, if the extension adds goods or services that are not distinct, an entity accounts for a contract modification with either a cumulative catch-up adjustment or by using a combination of the methods of modification accounting (see *Chapter G – Contract modifications; Accounting for contract modifications*).

Is the price of the added goods commensurate with stand-alone selling price?

To determine whether the modification should be accounted for as a separate contract, an entity evaluates whether the price of the additional distinct goods or services is commensurate with their stand-alone selling price (as adjusted for contract-specific circumstances). If the price of the additional distinct goods or services is not commensurate with stand-alone selling price, the modification is accounted for as a termination of the existing contract and creation of a new contract. If the price is commensurate, the modification is a separate contract.

The typical issue in a blend-and-extend modification is whether the stand-alone selling price should be compared to the overall increase in the contract value or the blended contractual cash selling price of the added goods or services.

When the overall price increase is not commensurate with the stand-alone selling price of the additional goods or services, the modification should be accounted for as a termination of an existing contract and the creation of a new contract. That is because neither the overall price nor the blended stated price would be commensurate with the stand-alone selling price.

The guidance is less clear when the overall increase in contract value is commensurate with the stand-alone selling price of the additional distinct goods or services, but the blended contractual cash selling price is not. In these cases, we believe the following approaches are acceptable.

Approach 1: Added services treated as a separate contract

Under this approach, an entity compares the overall contract price increase to the stand-alone selling price. This approach is based on a narrow reading of the condition in paragraph 606-10-25-12(b), which states that the "price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services …"

Under this approach, when the price of the *entire contract* increases in an amount that is consistent with the stand-alone selling price for the additional goods or services, the modification is treated as a separate contract. The entity uses the stand-alone selling price to account for the added goods or services, and the original contract price to account for the remaining items in the original contract. As a consequence, for accounting purposes the original contract remains unchanged even though the pricing in the agreement was modified.

Approach 2: Termination of existing contract and creation of a new contract

Under this approach, an entity compares the stated contract price of the additional goods or services to their stand-alone selling price. This approach is based on the basis for conclusions to ASU 2014-09 (BC77), which states a modification is accounted for as a separate contract when the "*pricing* for those goods or services reflects their stand-alone selling price." See *Chapter G – Contract modifications; Accounting for contract modifications* for a discussion of modifications accounted for as the termination of an existing contract and creation of a new contract.

Example G75.1 illustrates a blend-and-extend modification under the two approaches.

Example G75.1
Blend-and-extend contract modification

SaaS Co enters into a non-cancellable four-year contract with Customer to deliver 1 terabyte of online storage capacity per year for $60 per terabyte.

At the beginning of Year 3 (two years remaining in the contract), SaaS Co and Customer agree to a blend-and-extend modification to add two additional years. The modification increases the remaining term to four years.

Market prices have declined since inception of the original contract and the market price at the modification date is $50/terabyte. The overall contract price is increased based on the then-current market price for the added services ($100 for the two additional years at $50/terabyte) and blended with the pricing for the remaining term of the original contract.

As a result, the modified contract has four years remaining, priced at $55/terabyte:

$$((\$60/\text{terabyte} \times 2) + (\$50/\text{terabyte} \times 2)) / 4.$$

SaaS Co concluded that the original contract has a single performance obligation satisfied over time that is a series of distinct services and that the additional services are therefore distinct. As of the modification date, SaaS Co had recognized $120 of revenue and there were no contract assets or liabilities.

Because the overall price increased by the market price (i.e. stand-alone selling price) but the blended contractual price is not commensurate with stand-alone selling price, SaaS Co could account for the modification under either of the approaches described above in Question G75.

Approach 1: Added services treated as a separate contract

SaaS Co concludes that the overall contract price increases by the market price ($100), which is commensurate with the stand-alone selling price for the two additional terabytes. Therefore, SaaS Co accounts for the additional services as a separate contract.

	Year 3	Year 4	Year 5	Year 6
Revenue remaining on original contract	$60	$60	-	-
Revenue on new contract	-	-	$50	$50
Cash received	55	55	55	55
End-of-year contract asset/(liability)	**$ 5**	**$10**	**$ 5**	**$ 0**

Approach 2: Termination of existing contract and creation of a new contract

SaaS Co concludes that the blended contract pricing of $55/terabyte (i.e. the stated pricing for the additional 2 terabyte) is not commensurate with the stand-alone selling price of $50/terabyte. Therefore, SaaS Co accounts for the modification as a termination of the existing contract and a creation of a new contract.

	Year 3	Year 4	Year 5	Year 6
Revenue on new contract	$55	$55	$55	$55
Cash received	55	55	55	55

	Year 3	Year 4	Year 5	Year 6
End-of-year contract asset/(liability)	**$ 0**	**$ 0**	**$ 0**	**$ 0**

Question G80

When additional goods or services are priced at a discount from stand-alone selling price and the discount relates to past performance issues how should the entity account for that modification?

Interpretive response: Entities will need to evaluate the particular facts and circumstances to evaluate whether a discount provided in a modification relates to past performance or is a discount on future services. When an entity has evidence that a discount in a contract modification relates to the entity's past performance, the amounts related to the past performance issues should be accounted for as a change in the transaction price even if that discount is priced into the amendment on a prospective basis (see *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract; Changes in the transaction price*). Example 5, Case B in Topic 606 illustrates the accounting for a modification that adds additional goods or services and negotiates a discount related to past performance issues.

Example 5, Case B states that the minor defects in the initial 60 products transferred to the customer were 'unique'. While not stated explicitly, we believe this fact suggests there was no expectation of defects at contract inception that would have suggested there was variable consideration in the original contract. Further, we believe the 'unique' description of the defects is intended to suggest no defects are expected in the products remaining to be transferred to the customer after the modification and, therefore, that there is no variable consideration in the modified contract (i.e. for possible further concessions for additional defects).

In contrast, if the defects were not 'unique' to the 60 products initially transferred to the customer – i.e. such that there was a reasonable chance at contract inception that some of the products transferred would be defective – and the entity had previously provided similar concessions when products were defective, the entity likely should have concluded that the transaction price of the original contract included variable consideration. And even if there was no expectation of defects when the original contract was entered into, or any expectation of granting a concession in the event there were defects, the occurrence of the defects in the first 60 products transferred, and the granting of the $900 credit for those defective products, should raise questions about whether the transaction price for the modified contract (i.e. for the remaining 90 products not yet transferred at the modification date) includes variable consideration.

Excerpt from ASC 606-10

>>> Example 5 — Modification of a Contract for Goods

55-111 An entity promises to sell 120 products to a customer for $12,000 ($100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

>>>> Case B — Additional Products for a Price That Does Not Reflect the Standalone Selling Price

55-114 During the process of negotiating the purchase of an additional 30 products, the parties initially agree on a price of $80 per product. However, the customer discovers that the initial 60 products transferred to the customer contained minor defects that were unique to those delivered products. The entity promises a partial credit of $15 per product to compensate the customer for the poor quality of those products. The entity and the customer agree to incorporate the credit of $900 ($15 credit × 60 products) into the price that the entity charges for the additional 30 products. Consequently, the contract modification specifies that the price of the additional 30 products is $1,500 or $50 per product. That price comprises the agreed-upon price for the additional 30 products of $2,400, or $80 per product, less the credit of $900.

55-115 At the time of modification, the entity recognizes the $900 as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred. In accounting for the sale of the additional 30 products, the entity determines that the negotiated price of $80 per product does not reflect the standalone selling price of the additional products. Consequently, the contract modification does not meet the conditions in paragraph 606-10-25-12 to be accounted for as a separate contract. Because the remaining products to be delivered are distinct from those already transferred, the entity applies the guidance in paragraph 606-10-25-13(a) and accounts for the modification as a termination of the original contract and the creation of a new contract.

55-116 Consequently, the amount recognized as revenue for each of the remaining products is a blended price of $93.33 {[($100 × 60 products not yet transferred under the original contract) + ($80 × 30 products to be transferred under the contract modification)] ÷ 90 remaining products}.

Example G80.1

Contract to purchase additional software licenses at a discount due to bugs

On January 1, 20X7, ABC Corp. transfers 300 three-year term licenses to software Product K to Reseller at a fixed price of $10,000 per license (which is a 50% discount from ABC's well-controlled list price of $20,000). The contract includes an explicit promise to provide Tier 2 technical support to Reseller in supporting its customers. Because ABC provides unspecified updates, upgrades and enhancements to Reseller's customers, the contract with Reseller includes an implicit performance obligation to provide those unspecified items. Both the Tier 2 technical support and the unspecified updates, upgrades and enhancement rights are determined to be distinct from the licenses in the contract (see Questions C160 and C170). ABC accounts for the technical support and the unspecified updates, upgrades and enhancement rights as a single PCS performance obligation (see Question C150). Assume that based on the allocation guidance in Topic 606 – see *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract* – ABC allocates $1,800,000 to the 300 licenses and $1,200,000 to the three years of PCS.

Reseller proceeds to immediately resell the 300 licenses to its end-user customers. Six months later, ABC and Reseller enter into negotiations to transfer 200 Product M term licenses from ABC to be transferred six months from approval of the modification. That contract also includes explicit Tier 2 technical support and implicit rights to unspecified updates, upgrades and enhancements to be provided to Reseller's customers.

There was an unanticipated bug in the version of the Product K software that was more significant than those that typically occur in ABC's software releases. Because Reseller is responsible for Tier 1 technical support for its customers, it incurred unexpected technical support costs to help its customers navigate around the bug until ABC issued a patch on March 31, 20X7.

Because of the performance issues, and in order to preserve goodwill with Reseller (one of ABC's largest customers), ABC agrees to provide Reseller a credit in the form of an incremental discount on the 200 Product M licenses. ABC agrees to sell the 200 Product M licenses to Reseller at a price of $10,800 per license (a 55% discount from the list price of $24,000).

At the time the modification is approved, ABC recognizes the $240,000 incremental discount (200 Product M licenses × $1,200 [$12,000 (50% discount) – $10,800 (55% discount)]) as a reduction of revenue for the Product K licenses transferred. Absent the credit, ABC concludes that the contract for 200 Product M licenses (and the related PCS) is a separate contract – i.e. the Product M licenses (and related PCS) are distinct from the Product K licenses (and related PCS) and the price for the Product M licenses (and related PCS) reflect the stand-alone selling price for those items (see Question G90).

Because of the concession granted on the Product K licenses, ABC considers whether, in accordance with paragraph 606-10-32-7, the separate contract for the Product M licenses and PCS includes variable consideration in the form of a potential price concession for those licenses as well. Despite the concession granted on the Product K licenses, ABC concludes that Reseller would not validly expect a concession again unless there were similar performance issues with Product M as there were with Product K. Further, ABC does not have any history of granting concessions for non-performance reasons, and ABC is able to conclude that it is remote that any similar performance issues will arise with Product M. Therefore, ABC concludes that the Product M contract does *not* include variable consideration.

Consequently, ABC recognizes contra-revenue of $240,000 when the contract modification is approved related to the Product K licenses – i.e. because the defect was attributable to the originally transferred Product K licenses, ABC reflects the revenue reversal entirely as a reduction of software license revenue. Assume ABC allocates the $2,400,000 in consideration attributable to the Product M licenses and PCS ($12,000 × 200 Product M licenses) to the licenses ($1,440,000) and the PCS ($960,000). ABC will recognize the $1,440,000 allocated to the Product M licenses when control of the licenses is transferred to Reseller and will recognize the $960,000 allocated to the PCS over the three-year PCS period.

Example G80.2

Contract to extend SaaS arrangement that includes a discount for past performance issues

SaaS Company G enters into a contract with Customer to provide its SaaS for one year for a fee of $1,500 per month. The SaaS is a single performance obligation comprised of a series of distinct services. The contract does not include stated renewal options. With three months remaining in the contract, Company G and Customer enter into a new contract that extends the service for an additional year at $1,450 per month. $1,450 is below the stand-alone selling price for the SaaS of $1,550 for this class of customer. The remaining term of the original contract remains unchanged, and the entity will continue to charge $1,500 per month for the remaining three months. There are no changes to other terms or conditions of the original contract.

During the first eight months of the initial contract Customer experienced service issues that were unanticipated at contract inception. The service issues arose due to customer-specific circumstances that had not arisen previously in other customer contracts. Concurrent with the negotiation of the SaaS renewal, Customer communicates that it believes it should be entitled to compensation for those service issues even though the contract did not provide for service level penalties. Both Customer and Company G believe that, as of Month 9 of the initial contract, the service issues have been resolved and will not recur. Company G does not have any history of providing service level concessions when none are stipulated in the contract; it agrees to do so in this case because Customer is a new class of customer for Company G and it believes its arrangement with Customer will attract other similar customers to its SaaS solution.

As outlined in Question G70, performance issues and/or payment disputes generally create a presumption that at least some portion of the discount in a new contract, such as that in this example, is related to those performance issues or payment disputes that must be overcome by other evidence.

Consequently, Company G accounts for the modification as follows:

- First, Company G concludes that it should account for the entire discount from stand-alone selling price of $100 per month ($1,550 – $1,450) in the renewal contract as compensation for the past performance issues encountered in the first eight months of the original contract term. Company G concludes that this is reasonable given that the total discount for the 12-month renewal term of $1,200 equals 10% of the fees paid by Customer for the first eight months of deficient service under the original contract. 10% represents a reasonable service-level credit in the marketplace (e.g. when compared to entities that have explicit service-level provisions in their contracts). As a result, when the contract modification is agreed, Company G takes the $1,200 cumulative discount as a reversal to revenue recognized for the eight distinct months of SaaS it provided and for which there were service issues. The offsetting side of that revenue reversal is a contract liability, which will then be recognized into revenue as the renewal period SaaS is provided (see below).
- After reflecting the discount as a change to the transaction price for the first eight months of SaaS provided under the original contract, the remaining monthly consideration of $1,550 reflects the stand-alone selling price of the SaaS for the 12-month renewal period. Consequently, Company G does not adjust its accounting for the remaining three months of the original 12-month contract term – i.e. Company G continues to recognize $1,500 per month (assume Company G has determined that a time-based measure of progress is appropriate for the SaaS performance obligation) for the remaining three months of the original 12-month term.
- Company G accounts for the 12-month renewal as a separate contract. Company G will recognize $1,550 in revenue each month for the SaaS provided during the renewal period, comprised of the $1,450 Company G will bill the customer plus $100 each month reversed from the $1,200 contract liability established earlier.
- Because Company G believes that the initial service issues have been completely resolved and will not re-occur going forward, Company G does not expect to provide any further concessions to Customer, either for the remainder of the original contract term or for the renewal period. Similarly, Customer would not validly expect further concessions. Thus, there is no variable consideration to account for in the remainder of the original contract or the renewal contract.

Question G90

How should an entity evaluate the criterion in paragraph 606-10-25-12(b) when the stand-alone selling price of the additional distinct good or service is highly variable or uncertain?

Interpretive response: Evaluating whether the criterion in paragraph 606-10-25-12(b) is met for a contract modification that adds one or more goods or services with a highly variable or uncertain stand-alone selling price may require significant judgment. This is because a comparison of the additional consideration to *a* stand-alone selling price (or even a narrow range of stand-alone selling prices) is not possible.

Entities need to consider all relevant, available evidence in determining whether the amount of additional consideration promised for the good or service reflects its stand-alone selling price (as adjusted for particular contract circumstances). For example:

— One approach would be to compare the additional consideration for the good or service (e.g. the software license) or bundle of additional goods or services (e.g. multiple software licenses, or a license and PCS if the stand-alone selling price of *the bundle* is highly variable or uncertain – see Question E110) against the range of stand-alone selling prices for that good or service (or bundle of goods or services) estimated in previous contracts with similar customers. It may be, in the case of software arrangements, that the only added goods or services, as a bundle, have a highly variable or uncertain stand-alone selling price (e.g. a modification may add a software license and PCS that, as a bundle, have a highly variable stand-alone selling price).

— Another approach would be to evaluate whether the additional consideration for the good or service (or bundle of goods and services) provides a discount to the customer that is incremental to the range of discounts reflected in the pricing of the goods or services in the original contract. For example, assume the original contract for a five-year software license and two years of PCS priced the license at a 60% discount from the entity's list price (but priced the PCS at its stand-alone selling price – see Questions E130 and E140). In that case, a distinct license and PCS added through a contract modification (whether a renewal of the original license and PCS, or a new license and PCS to a different software product or granting additional rights to use the previously licensed product) would meet the criterion in paragraph 606-10-25-12(b) if the additional consideration resulting from the modification provides the customer with no more than a 60% discount from the *modification date* aggregate list price of that license (assuming the PCS for the added license is also, like the PCS for the original license, priced at its stand-alone selling price). In such case, the fact that the discount offered on the additional license is not incremental to the discount offered on the license in the original contract would typically support that the discount in the modification relates solely to the additional goods or services.

In some cases, the original contract may have been modified multiple times before the most recent modification was approved. In such cases, when applying this second approach, the discount in the modification should be compared against the discount(s) offered in the contract(s) or amendment(s) last entered into before the current modification date. For example, assume the original contract with the customer for a five-year software license and two years of PCS priced the license at a 60% discount from list price (and the PCS at its stand-alone selling price – see Questions E130 and E140). However, the parties have subsequently entered into a number of additional contracts to grant the customer (1) the right to use additional software products or (2) additional users or capacity, and related PCS on both. Assume that at the time of the current modification, the customer's active licenses (i.e. those that have been renewed multiple times, as well as new licenses added in the most recent previous amendment) were priced at a 70% discount from list price, while the related PCS is priced at stand-alone selling price. That discount of 70%, while incremental to the discount in the amendment that preceded it, was considered an 'appropriate adjustment to the stand-alone selling price' (see Question G70). Therefore, when applying this approach to the current modification adding a new license and PCS, it would meet the criterion in paragraph 606-10-25-12(b) if the additional consideration resulting from the modification provides the customer with no more than a 70% discount from the list price of the new license (assuming the PCS is priced at stand-alone selling price).

If the discount from list price in either of the two preceding paragraphs exceeded 60% and 70%, respectively, that would not *automatically* mean the criterion in paragraph 606-10-25-12(b) is not met. The entity would still consider whether the incremental discount is an 'appropriate adjustment to the stand-alone selling price' (see Question G70).

Whatever approach an entity adopts, we would expect it to be applied consistently in similar circumstances, and to the extent the entity's approach relies on established list prices, those list prices must be substantive. In addition, changes to the price list should be subject to the entity's internal controls (including who can authorize its updating) and there should be a process and controls for identifying any triggers resulting in adjustments to the price list.

Example G90.1

Evaluating whether additional consideration reflects the stand-alone selling prices of added goods and services

ABC Corp. sells a perpetual software license to software Product A to Customer along with three years of technical support and rights to when-and-if available updates/upgrades (collectively, PCS). The contract price for the license and the PCS is $400,000 and $216,000, respectively, which is paid upfront. ABC does not sell its software licenses to Product A separately from PCS, but sells Product A PCS separately through renewals. The list price for the Product A license is $1,000,000; so the contract price for the license is a 60% discount from list price. ABC's price list is substantive and well controlled. ABC's customary business practice is to sell Product A PCS for one year at 18% of the contractual license fee, and ABC has a substantial history of selling one-year PCS renewals on a stand-alone basis at that price.

Two years after entering into the contract for the Product A license and PCS, ABC and Customer enter into an amendment to grant Customer a perpetual license to software Product B along with one year of PCS. The contract prices are $300,000 and $60,000, respectively. The list price for the Product B license is $600,000; so the contract price for the license is a 50% discount from list price. ABC's customary business practice is to sell one-year of Product B PCS to customers similar to Customer for 20% of the contractual license fee, and ABC has a substantial history of selling PCS renewals on a stand-alone basis at that price.

ABC has concluded that the stand-alone selling price for a perpetual Product B license is highly variable.

Product B has been licensed on a perpetual basis to many similar customers within the last few months, always bundled with one year of PCS.

Alternative 1

The Product B PCS is being sold at its stand-alone selling price (consistent with Example E130.1). Therefore, ABC compares the discount from list price offered on the Product B license in its previous Product B perpetual license sales to the discount from list price given to Customer. The discount from list price in the previous Product B perpetual license sales is calculated as the difference between:

— the estimated stand-alone selling price established for the Product B license and
— the then-current ABC list price.

From this process, ABC determines that the normal range of discounts it has previously provided from the list price on perpetual licenses of Product B is 40% to 60%. Therefore, the 50% discount from list price is not incremental to the entity's 'normal' discount range. Together with the fact that the PCS is priced at its observable stand-alone selling price, and assuming the Product B license and related PCS are distinct from the Product A license and PCS promised in the original contract, ABC accounts for the Product B license/PCS amendment as a separate contract in accordance with paragraph 606-10-25-12.

Alternatively, if the normal range of discounts ABC previously provided from the list price on perpetual licenses of Product B was lower than the 50% discount offered to Customer (e.g. 25% to 40%), ABC would generally account for the amendment as a contract modification. That is, unless the difference reflects an 'appropriate adjustment' to the stand-alone selling price of the license to reflect particular contract circumstances – see Question G70 – the amendment is treated as a contract modification, rather than as a separate contract.

Alternative 2

ABC compares the discount from list price granted on the Product B license of 50% to the 60% discount from list price provided on the Product A license in the original contract with Customer. Consequently, again assuming the Product B license and related PCS are distinct from the Product A license and PCS promised in the original contract, ABC accounts for the Product B license/PCS amendment as a separate contract in accordance with paragraph 606-10-25-12.

Note:

If the discount from list price offered on the license to Product B was more than 60%, ABC would generally account for the amendment as a modification to the original contract – i.e. unless the difference reflects an 'appropriate adjustment' for the particular contract circumstances (see Question G70).

Example G90.2

Evaluating whether additional consideration reflects the stand-alone selling prices of added goods and services that do not all have highly variable or uncertain stand-alone selling prices

ABC Corp. sells a three-year term software license to software Product H to Customer along with three years of technical support and rights to unspecified updates, upgrades and enhancements (collectively, PCS) and professional services to implement the software. The contract prices for the license, the PCS and the professional services are $400,000; $216,000; and $200,000, respectively. The list price for the Product H license is $1,000,000; so the contract price for the license is a 60% discount from list price. ABC's price list is substantive and well controlled. ABC's customary business practice is to sell Product H PCS at a price equivalent to 18% of the contractual license fee per year (so in a three-year license, the PCS fee would be 54% of the contractual license fee). The $200,000 professional services fee reflects the observable stand-alone selling price for ABC's professional services (established through stand-alone sales of professional services) – 800 anticipated hours at an observable rate of $250 per hour.

One year after entering into the original contract, ABC and Customer enter into an amendment to grant Customer a two-year term license to software Product J along with two years of PCS and implementation services. The contract prices are $300,000; $120,000; and $100,000 respectively. The list price for the Product J license is $600,000; so the contract price for the license is a 50% discount from list price. ABC's customary business practice is to sell Product J PCS to customers similar to Customer at a price equivalent to 20% of the contractual license fee per year of the license term (so in a two-year license, the PCS fee would be 40% of the contractual license fee). The $100,000 professional services fee reflects the observable stand-alone selling price for ABC's professional services (established through stand-alone sales of professional services) – 400 anticipated hours at an observable rate of $250 per hour.

ABC concludes that the stand-alone selling price for the Product J license and co-terminus PCS as a bundle is highly variable because that price varies in direct proportion to the widely varied discounts ABC grants on term licenses to Product J.

Product J has been licensed to many similar customers within the last few months, always bundled with co-terminus PCS; most of those customers have also engaged ABC to implement the software. For those customers, ABC used a residual approach when first allocating consideration between the professional services and the Product J license and co-terminus PCS as a bundle.

Alternative 1

In determining whether the additional consideration for the Product J license and related services in the amendment reflects the stand-alone selling prices for those items, ABC undertakes the following evaluation:

— ABC first 'carves off' a portion of the additional consideration equal to the observable stand-alone selling price of the professional services.

— ABC then compares the discount from list price offered on the Product J license/PCS bundle in its previous Product J license sales as compared to the discount from list price given to Customer in this amendment (calculated as the difference between (1) the remaining, residual amount of the additional consideration in the amendment after carving off an amount equal to the observable stand-alone selling price of the professional services and (2) list price for the bundle).

ABC determines that the normal range of discounts it has previously provided from the list price on licenses of Product J with bundled PCS is 35% to 55%. Meanwhile, the discount from list price for the Product J license/PCS bundle in the amendment is 50%. Therefore, the discount from list price in the amendment is not incremental to the entity's 'normal' discount range. Together with the fact that the professional services to implement the Product J software are priced at their observable stand-alone selling price, ABC concludes that the additional consideration to be paid by Customer for the Product J license, PCS and professional services reflects the stand-alone selling prices of those items. Therefore, assuming the Product J license, the PCS and the professional services are distinct from the license and services promised in the original contract, ABC accounts for the Product J amendment as a separate contract in accordance with paragraph 606-10-25-12.

Alternative 2

Because ABC concludes the bundles of (1) the Product H license and co-terminus PCS and (2) the Product J license and co-terminus PCS have a highly variable stand-alone selling price, ABC calculates a *blended* discount from list price for both the original contract and the amendment.[1] The discount in the original contract for the Product H license, the PCS and the professional services from their aggregate list price is 53.1%, calculated as the total contract price ($816,000 = $400,000 + $216,000 + $200,000) ÷ the total list price ($1,740,000 = $1,000,000 + $540,000 + $200,000). The discount from list price in the amendment for the Product J license, PCS and professional services is 44.7%, calculated as the total amendment consideration ($520,000 = $300,000

+ $120,000 + $100,000) ÷ the total list price of the license and services added in the amendment ($940,000 = $600,000 + $240,000 + $100,000).

Because the blended discount on the amendment of 44.7% is less than the blended discount of 53.1% in the original contract, and assuming the Product J license and related PCS are distinct from the license and services promised in the original contract, ABC accounts for the Product J license/PCS/implementation services amendment as a separate contract in accordance with paragraph 606-10-25-12.

Note:

1. The calculation illustrated may not be the only acceptable method for applying this alternative. Because ABC has observable stand-alone selling prices for its professional services, we believe it also would be acceptable in this scenario to carve off the contract and observable stand-alone selling prices for the professional services, in which case the discount in the original Product H contract for the license/PCS bundle from list price would be 60%, while the discount from list price in the Product J amendment for the license/PCS bundle would be 50%.

Question G100

When a modification is accounted for prospectively in accordance with paragraph 606-10-25-13(a), is a contract asset that exists at the modification date written off?

Interpretive response: No. At the April 2016 TRG meeting, TRG members agreed that a contract asset that exists at the modification date should not be written off. Rather, any contract asset (in which case there would not be any contract liability) is carried forward to the modified contract, less any impairment resulting from the modification to the contract (e.g. because of the loss of contractual fees for a canceled good or service or resulting from a price change). TRG members observed that a write-off of the contract asset would result in a reversal of previously recognized revenue, which would be inconsistent with a *prospective* accounting model and the Board's conclusions articulated in the Basis for Conclusions to ASU 2014-09 (BC78).

When a modification is accounted for prospectively in accordance with paragraph 606-10-25-13(a), the guidance provides a specific formula to determine the amount of consideration allocated to the remaining performance obligations. Paragraph 606-10-25-13(a)(1) explicitly requires that the starting point for that determination is the transaction price in the original contract *less* what had already been recognized as revenue. A contract asset represents revenue that has been recognized under the contract and, therefore, to calculate the consideration to be allocated to the remaining performance obligations the entity reduces the transaction price by the amount of the contract asset that has been recognized (see Example G100.1 below).
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Example G100.1

Contract asset in a modification accounted for prospectively as a termination of the original contract and the creation of a new contract

ABC Corp. provides a hosted software solution to customers. Customers are not permitted to take possession of ABC's software. ABC and Customer enter into a contract for Customer to use ABC's SaaS for two years. ABC charges a monthly fee of $10,000 during Year 1 and $15,000 in Year 2. The transaction price for the contract is therefore $300,000.

ABC concludes that the SaaS performance obligation is satisfied over time (see Question F130) and uses a time-elapsed measure of progress to recognize revenue. ABC further concludes that the single performance obligation is a series of distinct services in accordance with paragraph 606-10-25-14(b).

In Year 1, ABC recognized $150,000 of revenue ($300,000 total transaction price × 50% completion), which resulted in a contract asset of $30,000 because the entity has only been entitled to bill $120,000 through the end of Year 1 – i.e. further billings are conditional upon ABC providing the SaaS in Year 2.

At the beginning of Year 2, ABC and Customer agree to modify the contract to provide Customer access to an additional, distinct hosted solution (i.e. additional SaaS) for Year 2 for $5,000 per month. The stand-alone selling price of the added SaaS is $10,000 per month. The additional consideration to be charged by ABC of $5,000 per month is a significant discount from the stand-alone selling price for access to that solution. ABC concludes that the discount from stand-alone selling price is not an 'appropriate adjustment' for particular contract circumstances (see Question G70). Because the additional consideration for the added distinct service does not reflect its stand-alone selling price and the difference between the additional consideration and the stand-alone selling price cannot be attributed to an 'appropriate adjustment', the modification is not a separate contract in accordance with paragraph 606-10-25-12.

Because the SaaS provided under the original contract is a series of distinct services, the remaining services to be provided from the original SaaS and the services to be provided from the added SaaS are each distinct from the SaaS already provided before the modification. Consequently, the modification is accounted for prospectively as a termination of the existing contract and creation of a new contract in accordance with paragraph 606-10-25-13(a).

The consideration allocated to the remaining performance obligations is calculated as follows.

Transaction price in original contract	$300,000
Less: Consideration previously recognized as revenue	150,000
Plus: Consideration promised in modification	60,000
Total remaining revenue to be recognized	**$210,000**

The consideration allocated to the remaining performance obligations of $210,000 is less than the amount of consideration the entity will receive under the modified contract of $240,000 ($20,000 × 12 months). The difference between the future billings and the amount that will be recognized as revenue ($30,000) will reduce the contract asset that exists at the modification date as amounts are billed in excess of revenue recognized.

The following table illustrates the revenue that will be recognized and the contract asset balance that will exist throughout the remainder of the modified contract.

12 remaining months of the modified contract	Revenue recognized	Contract asset balance
End of Month 1	$17,500	$27,500
End of Month 2	17,500	25,000
End of Month 3	17,500	22,500
End of Month 4	17,500	20,000
End of Month 5	17,500	17,500
End of Month 6	17,500	15,000
End of Month 7	17,500	12,500
End of Month 8	17,500	10,000
End of Month 9	17,500	7,500
End of Month 10	17,500	5,000
End of Month 11	17,500	2,500
End of Month 12	$17,500	$ –

Question G110

How should an entity account for a modification that *decreases* the scope of a contract?

Interpretive response: A decrease in scope may involve any of the following:

- the complete termination of the contract such that the entity has no obligation to transfer goods or services to the customer;
- canceling one or more, but not all, of the goods or services promised under the original contract – e.g. an entity and a customer may agree to terminate hosting services being provided by the entity if the customer decides to take possession of the software; or
- partially terminating one or more of the goods or services – e.g. shortening a contracted SaaS or PCS period.

A scope decrease modification can never be accounted for as a separate contract because the criterion in paragraph 606-10-25-12(a), which requires that the modification *add* distinct goods or services, will never be met.

Therefore, the accounting for a scope decrease modification depends on whether the remaining goods or services in the existing contract are distinct from those goods and services transferred before the modification.

If the remaining goods or services are distinct from those transferred on or before the date of the contract modification (e.g. in a long-term services contract that is a series of distinct, shorter service periods – such as a SaaS arrangement or a PCS renewal, at any point in time during the contract term, the remaining services to be provided are distinct from those already provided), the modification is accounted for prospectively as a termination of the existing contract and the creation of a new contract in accordance with paragraph 606-10-25-13(a).

If the remaining goods or services are not distinct from those transferred on or before the date of the contract modification (e.g. services to complete in-process software customizations), the modification is accounted for on a cumulative catch-up basis in accordance with paragraph 606-10-25-13(b).

Termination penalty in partial termination scenario

A partial termination may relate to a customer exercising an option to terminate the contract. As discussed in *Chapter B – Step 1: Identify the contract with the customer*, a substantive termination penalty evidences that rights and obligations exist throughout the term to which the penalty applies – i.e. that a termination option during that period is not substantive. Once the contract term is established, the entity accounts for the contract on that basis – i.e. the entity's accounting for the contract ignores the termination option(s) and the transaction price of the contract does not include the termination penalty. If the contract is subsequently terminated (whether immediately, or with effect in the future but before the initially determined contract term expires), the termination is accounted for as a contract modification even though the terms and conditions of the contract have not been changed (see Question B140). The substantive termination penalty that the customer must pay is consideration promised as part of the contract modification.

Example G110.1

Decrease in scope (and price) of PCS

ABC Corp. enters into a software license agreement with Customer to provide a license to software Product X as well as premium technical support services and the right to unspecified updates, upgrades and enhancements for two years in exchange for total consideration of $150, $130 upfront and $20 at the beginning of Year 2. Premium technical support entitles Customer to 24/7 technical support and faster support response times as compared to standard support.

ABC concludes that the technical support services and the unspecified update, upgrade and enhancement rights are a single PCS performance obligation (see Question C150) that constitutes a series of distinct service periods (see Question C140). The Product X license and the PCS are determined to be separate performance obligations in this contract (see Questions C160 and C170). Of the $150 transaction price, $100 is allocated to the license and $50 is allocated to the PCS. Product X license revenue is recognized upon transfer of control of the license to the customer (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*) – assume that occurs at contract inception in this example. The PCS revenue will be recognized over the 24-month service period, and ABC has determined that a time-based measure of progress is appropriate (see Question F220).

At the beginning of Year 2 of the contract term, the parties modify the contract to reduce the level of technical support from premium to standard. As of the modification date, ABC has recognized revenue of $100 for the transfer of the Product X license and $25 for the PCS provided to date (i.e. $125 in total). ABC has received $130 in payment from Customer and, therefore, has recorded a contract liability of $5 ($130 – $125) at the modification date. As part of the modification, the parties agree to a reduction in the overall price such that Customer will make a second payment of only $10, rather than $20. Therefore, the total consideration Customer will ultimately pay under the contract is $140 rather than the $150 originally agreed upon.

In this example, the remaining one year of PCS is distinct from both the Product X license transferred to Customer at contract inception and the PCS provided in the first year of the contract. Accordingly, the decrease in scope and price is accounted for prospectively as a termination of the existing contract and the creation of a new contract. In accordance with paragraph 606-10-25-13(a), $15 is allocated to the PCS that remains to be provided for the second year of the contract (the $5 collected in payments not recognized as revenue – i.e. the contract liability balance – plus the $10 remaining to be paid under the modified contract) and will be recognized over the remaining 12-month PCS period, continuing to use a time-based measure of progress.

Example G110.2

Partial termination of SaaS contract – no customer termination right

SaaS Company G enters into a three-year contract with Customer to provide Customer with access to its hosted software solution at $2,000 per month. The contract does not provide Customer with a termination right. Company G concludes the contract has a single performance obligation that consists of a series of distinct services. Company G also concludes the performance obligation is satisfied over time and uses a time-elapsed measure of progress to recognize the transaction price. At the end of Year 1, G has recognized $24,000 of revenue ($72,000 transaction price × 1/3 complete).

At the beginning of Year 2, technological advances and competition in the market has changed the needs of Customer for this particular solution. Both parties agree to shorten the remaining term of the contract from two years to one year (i.e. reduce the original three-year term by one year, to two years in total). As part of this contract modification, Customer agrees to pay a negotiated termination penalty of $12,000.

The criteria to account for the modification as a separate contract is not met given the scope of the contract does not increase (i.e. no distinct goods or services are added). Because the performance obligation is a series of distinct services, the remaining SaaS periods subsequent to the modification are distinct from those before the modification. Therefore, the modification is accounted for prospectively as a termination of the original contract and the creation of a new contract in accordance with paragraph 606-10-25-13(a).

Consequently, Company G allocates consideration to the remaining distinct SaaS periods based on the original contract consideration that had not yet been recognized as revenue plus the consideration promised as part of the modification. The entity had not yet recognized $48,000 ($72,000 transaction price – $24,000 recognized as revenue in Year 1) of the original transaction price. The consideration received as part of the modification includes the penalty of $12,000 and a reduction of the monthly payments of $24,000. As such, Company G will recognize $36,000 ($48,000 + $12,000 – $24,000) prospectively over the remaining year of the modified contract.

Example G110.3

Partial termination of SaaS contract that includes customer termination right subject to termination penalty

Assume the same facts as Example G110.2, except the contract includes a termination clause that would allow Customer to shorten the contract by one year (i.e. cancel the third year of the SaaS) at any time during the first two years – Customer cannot cancel the third year of the contract after the end of the second year. If Customer exercises its termination right, it is required to pay a contractually specified termination penalty of $12,000. Company G concludes the penalty is substantive and, therefore, considers the contract to have a three-year term (see Question B140).

At the beginning of Year 2, Customer decides to exercise its option to cancel Year 3 of the contract and pay the substantive termination penalty. Company G accounts for this partial termination as a contract modification because the scope of the contract decreases. Consistent with the termination payment negotiated as part of the modification in Example G110.2, Customer's termination payment is accounted for as promised consideration under the modified contract and recognized prospectively as consideration received as part of the contract modification. Company G will recognize $36,000 ($24,000 contractual payment for Year 2 + $12,000 termination payment) prospectively over the remaining year of the modified contract.

Question G120

How should an entity account for a contract modification that consists of a change in price only?

Interpretive response: An entity would account for a contract modification that affects only the price of a contract in the same way as a modification that results in decreased scope (see Question G110). The change in price is accounted for either prospectively or on a cumulative catch-up basis depending on whether the remaining promised goods or services to be delivered as of the date of the modification are distinct from those goods or services delivered before the modification. This type of modification can never be accounted for as a separate contract because the criterion in paragraph 606-10-25-12(a), which requires that the modification add distinct goods or services, will never be met.

If the remaining goods or services are distinct from those transferred on or before the date of the contract modification (e.g. if the remaining services are part of a series of distinct, shorter service periods – such as a SaaS arrangement or a PCS renewal – at any point in time during the contract term, the remaining services to be provided are distinct from those already provided), the modification is accounted for prospectively.

If the remaining goods or services are not distinct from those transferred on or before the date of the contract modification (e.g. services to complete in-process software customizations), the modification is accounted for on a cumulative catch-up basis.

Entities should be cognizant of the fact that any pattern (or customary business practice) of granting price reductions to existing contracts, with no changes to the scope of the contract (e.g. adding or reducing goods or services), will generally 'taint' future contracts as having variable consideration, subject to the Topic 606 guidance on variable consideration, including the constraint (see *Chapter D – Step 3: Determine the transaction price*).

Example G120.1

Price decrease – SaaS arrangements

ABC Corp. provides customers with access to a hosted software solution for which they generally pay a fixed monthly fee. Customers are not permitted to take possession of ABC's software; therefore, the arrangements are SaaS arrangements. ABC and Customer enter into a contract for Customer to use ABC's SaaS for three years. ABC concludes that the SaaS is a single performance obligation consisting of a series of distinct service periods – i.e. each period (day, week, month, quarter) within the contract term is distinct from the others.

At the end of Year 1, ABC and Customer agree to decrease the monthly fee on a prospective basis. The decrease in fee is a result of technological advances and competition in the marketplace. The change in price is not attributable to prior service issues. Further, ABC does not have a pattern of granting price decreases without a commensurate change in scope of the contract; therefore, a price change was not expected at contract inception (i.e. there was not variable consideration in the original contract).

The modification does not result in a separate contract because no additional goods or services are added, and therefore the criterion in paragraph 606-10-25-12(a) cannot be met. Because the SaaS performance obligation is a series of distinct SaaS periods, the SaaS not yet provided as of the date of the modification is distinct from the SaaS already provided to Customer pre-modification. Consequently, ABC accounts for the modification prospectively, as a termination of the existing contract and the creation of a new contract in accordance with paragraph 606-10-25-13(a). ABC will recognize the remaining consideration to be paid for Years 2 and 3 of the contract plus any consideration received from Customer but not yet recognized as revenue (i.e. any contract liability balance) over the remaining two-year SaaS period.

Example G120.2
Change in price in software customization contract

ABC Corp. enters into a contract with Customer to license software Product K and to significantly customize the software for Customer's use. The license and the customization services are a single performance obligation, consistent with the discussion (and example) in Question C230. Customer agrees to make progress payments throughout the customization period, which is expected to be approximately 18 months. The transaction price is fixed at $1,000,000. ABC concludes that the single performance obligation is satisfied over time (see Question F200). At contract inception, ABC expects the following.

Transaction price	$1,000,000
Expected costs	600,000
Expected profit (40%)	**$ 400,000**

ABC applies a cost-to-cost input measure of progress to the combined performance obligation. After eight months of the contract, ABC has satisfied 40% of its performance obligation measured on the basis of costs incurred ($240,000) relative to total expected costs ($600,000). The cumulative revenue and costs recognized for the first year are, therefore, as follows.

Revenue	$ 400,000
Costs	240,000
Gross profit	**$ 160,000**

At the beginning of Month 9, Customer notifies ABC that it intends to scale back the scope of the customizations due to budgetary concerns resulting from a downturn in their business – Customer indicates that they can effect cheaper 'workarounds' for certain tasks they originally intended ABC's software to perform. In the interest of maintaining a long-term relationship with Customer, ABC agrees with Customer to reduce the contract price to $900,000 from $1,000,000, without reducing the scope. ABC agrees to do this because the margin it will earn based on that contract price is still acceptable to ABC. ABC does not have a history of granting these types of price concessions to its customers and the price reduction does not reflect any issues with ABC's performance under the contract (or any prior contracts). ABC also did not expect Customer to experience the downturn it has experienced or to react to the downturn by attempting to reduce the scope of its contract with ABC. Therefore, ABC validly did not anticipate providing a concession to Customer (note: ABC's willingness to grant this concession should be considered by ABC in future contracts when determining whether there is variable consideration in those contracts). ABC considers the adjusted margin it will earn from the contract subsequent to the price reduction as acceptable, but will not consider any further price reductions under the present scope of the contract because the resulting margin would not be acceptable.

At the date of the price change agreement, the remaining customization services to be performed are not distinct from ABC's performance to date. Therefore, ABC updates the transaction price of the contract for the agreed price change to $900,000 from $1,000,000 and records a downward revenue adjustment of $40,000 (40% completion to date × $100,000 price reduction) as of the date the modification is agreed. For the remainder of the contract, ABC will base its revenue on its measure of progress to date in relation to the revised, lower transaction price for the modified contract of $900,000.

Question G130

What is the appropriate accounting for a modification that adds rights granted under a software license?

Background: A software license refers to a customer's rights to use the entity's software, which may be effectively unlimited (e.g. perpetual, worldwide and unlimited as to use) or restricted as to time, geography or use. A software license will frequently provide rights of use for only a defined term and may limit the customer's use of the software to specific territories or uses (e.g. embedding in a particular class of customer product only).

A modification may change the customer's rights to use the entity's software. A modification could increase or decrease the customer's rights to use the software or grant the customer rights to use a different software product. A modification typically, but not always, involves a change in consideration.

In a modification that add rights, the entity and the customer could agree to expand the customer's rights to use the entity's software for additional fixed fees or additional sales-based royalties. The expansion of rights could be similar to the additional rights granted in Example 61B in Topic 606 (reproduced in Chapter F), whereby the parties could agree to permit the customer to embed the entity's software in additional classes of the customer's consumer products.

See Question G131 for a discussion about modifications that decrease the customer's license rights.

Interpretive response: Because a license is a bundle of rights to use IP, additional rights that must be granted to a customer represent one or more additional licenses, even if those additional rights relate to use of the same software product (see Question C10).

For example, the right described in the background to embed the entity's software in an additional class of the customer's consumer products is an additional software license granted to the customer – i.e. in addition to the software license granted in the original contract – even though the customer already has other rights to use the same software product.

The additional license will typically be distinct from the original software license(s) and related services (e.g. PCS or hosting services). Therefore, the accounting for the modification depends on whether the pricing of the additional license is commensurate with stand-alone selling price after considering appropriate adjustments.

Price commensurate with stand-alone selling price

In this case, the modification granting the additional license(s) is accounted for as a separate contract (see Questions G70 and G90).

Price not commensurate with stand-alone selling price

In this case, the modification granting the additional license(s) is typically accounted for as a termination of the original contract and creation of a new contract. In accounting for this type of modification, any previously recognized revenue is not adjusted. The remaining, unrecognized consideration from the original contract and the additional consideration from the modification, net of any existing contract asset (see Question G100), is allocated to the remaining goods and services to be provided under the modified contract (e.g. the new license). The goods and services provided under the modified contract are the additional rights granted, any new services related to those licenses and any remaining services from the original contract such as remaining periods of PCS related to the licenses transferred as part of the original contract.

See Question G140 for a discussion of when the amounts allocated to the additional licenses are recognized.

Question G131

What is the appropriate accounting for a modification that decreases rights granted under a software license?

Background: Question G130 discusses modifications that add rights to use software in a modification. A modification could also decrease a customer's rights to use software. Examples of modifications decreasing customer rights to use software (i.e. its license rights) include:

— the parties agree to impose new restrictions on how the customer can employ the entity's software in return for a decrease in the fees to be paid over the remainder of the license period;
— the parties agree to shorten the license term either for a reduction of fees or a refund of fees already paid;
— the parties agree to reduce the number of seat/user licenses in exchange for a reduction in fees; and
— the parties agree to convert the customer's software license to a SaaS subscription, forfeit the customer's existing license (Question G132 addresses adding an *option* to convert a license to SaaS).

This Question is limited to the accounting for modifications that decrease a customer's license rights and not contracts where an explicit *or implicit* customer right to return, exchange or convert its license rights was a part of the original contract (see 'Implied rights' discussion in the response below).

Interpretive response: When previously transferred license rights are revoked through contract modification, the revocation is generally accounted for as a return of those rights (like the return of a good, given that a license is generally accounted for as the transfer of a product at a point in time – see chapter F), which typically results in a revenue reversal at the modification date (the return approach).

However, there is an alternative view that the entity can or should account for the modification prospectively (the prospective approach), without any revenue reversal for the forfeited rights. Instead, the effect of the modification is solely prospective (e.g. the license rights end for some seat licenses, while they continue for others along with related PCS, or the license rights end and SaaS commences in their place). Therefore, consistent with other prospective modifications, no revenue reversal would result. [ASU 2014-09.BC78]

Issue 2 of EITF Issue 19-B "Revenue Recognition – Contract Modifications of Licenses of Intellectual Property" was added to the FASB agenda to address this diversity in practice in the accounting for the revocation of licensing rights (including conversion of term software licenses to SaaS). The FASB subsequently removed the project from its technical agenda without amending US GAAP. As a result, this diversity in practice remains. Absent renewed action by the FASB, or guidance from the SEC staff, we believe either approach is acceptable and should be applied consistently to similar modifications.

Return approach

Under the return approach, a refund, credit or price reduction on remaining elements of the contract (e.g. a price reduction on remaining PCS) attributable to those revoked rights would be recognized as a reduction of revenue at the modification date. The credit would include any amount netted within an overall increase in consideration – e.g. because the modification also included the addition of goods or services.

The amount attributable to revoked rights is a matter of judgment that depends on the facts and circumstances. In most cases, we expect that amount would consider the revenue initially recognized for those revoked rights (e.g. the portion of the transaction price originally allocated to that license) and the rights that have already been 'consumed' if a portion of the license term has passed before the cancellation (see Example G131.1). However, in general we would not expect the reversal to result in the entity recognizing revenue in excess of stand-alone selling price for the remaining goods or services.

While we would generally expect a license cancellation to result in a revenue reversal under the return approach, that may not always be the case. If there is evidence to support that no refund, credit or price reduction was issued for the value of the cancelled rights then it would typically be appropriate *not* to record a revenue reversal. The following are examples of when no reversal may be appropriate under the return approach:

- A license is cancelled and accompanied only by the addition of a distinct good or service for which the customer will pay an incremental amount of consideration that is commensurate with observable stand-alone selling price.
- A license is cancelled within a larger contract but no additional items are added in the modification, no explicit credit or refund is given, and the

remaining consideration excluding a potential reversal to be allocated to the remaining goods or services after the cancellation reflects the stand-alone selling prices. For example, the modified contract includes a number of other licenses not being canceled and PCS for those remaining licenses with no added goods or services.

— A perpetual license is cancelled after the expiration of its economic life and there is no other evidence suggesting that the entity issued a refund, credit or price reduction for any remaining value of the license.

In addition, there may be other, more limited scenarios where there is evidence that no value should be ascribed to the cancelled license.

Prospective approach

Under the prospective approach, if the only modification is the reduction in license rights, the existing contract is deemed terminated and a new contract created. Consequently, the remaining, unrecognized transaction price is allocated to the remaining performance obligations in the new contract (e.g. PCS over remaining licenses or new SaaS) and no previously-recognized revenue is reversed. This may result in revenue being recognized for the remaining performance obligations that is significantly below their stand-alone selling prices.

Importantly, this approach only applies to a license rights reduction. If a license rights reduction is coupled with other modifications to the contract, there may still be a cumulative revenue effect at the modification date depending on the nature of those other modifications (see Question G150).

Implied rights

A pattern of entering into modifications that permit a customer to reduce its license rights should be considered by an entity when entering into new or modifying other existing contracts. Such a pattern likely suggests there is an implicit right of return or SaaS conversion option in these contracts at their inception.

If a refund liability for a license or a material right has previously been established, the subsequent exercise by the customer of its return right or conversion option is not a contract modification. Questions C70, C80 and C85 discuss the accounting for software license return, exchange and SaaS conversion rights, respectively, that exist at contract inception, whether explicit or implied.

Because of this, the applicability of this Question – as compared to those enumerated in the preceding paragraph – may be short-lived for many entities. Once a pattern of entering into these types of modifications emerges, an entity will generally be looking to the guidance in those questions to account for the customer’s implied rights.

Example G131.1

Contract modification revoking rights previously transferred

ABC Corp. enters into a contract with Customer to transfer a license to software product T and provide technical support and unspecified updates, upgrades and enhancements (collectively, PCS) for a three-year period.

The following additional facts are relevant.

- The contract price for the license is $200,000 per year, while the contract price for the PCS is $120,000 per year (both fees paid annually in advance). In this example, payment of the license fee over time does not create a significant financing component.
- The contract term is determined to be three years because the parties have enforceable rights and obligations for the full three years – there are no cancellation or termination provisions.
- The PCS is determined to be a single performance obligation (see Question C150), while the software license and the PCS are determined to be separate performance obligations (see Question C170).
- The contract prices represent the stand-alone selling prices for each performance obligation. The stand-alone selling price of the bundled term license and PCS is highly variable (see Question E110).
- The software license is transferred to Customer at contract inception.
- The PCS is satisfied over time (see Questions F150 and F160), using a time-based measure of progress (see Question F220).

ABC records the following journal entry for Year 1.

	Debit	*Credit*
Cash	320,000	
Contract asset	400,000	
PCS revenue		120,000
License revenue		600,000
To recognize revenue on transferred software license, and establish contract asset and contract liability.		

At the beginning of Year 2, ABC and Customer modify the contract; cancelling Customer's license to product T and the related PCS, and converting that arrangement to a SaaS subscription for the remaining two years of the contract; under the subscription, Customer will not have the right to take possession of the product T software (i.e. will not take product T on-premise). As part of the modification, Customer will continue to make annual payments of $320,000 in advance, which represents the observable stand-alone selling price of the SaaS at the modification date.

There were no customer cancellation or return rights in the original contract, nor was there any reason (e.g. ABC's customary business practices) for Customer or ABC to *infer* that a right to cancel (i.e. return) the product T license at contract inception existed. Consequently, ABC did not establish a refund liability at contract inception and both the cancellation of the product T license and the addition of the SaaS subscription at the beginning of Year 2 are modifications of the original contract.

Because the modification adds a distinct SaaS subscription priced at its stand-alone selling price but also cancels rights in the original contract, ABC accounts for the SaaS subscription prospectively as a termination of an existing contract and creation of a new contract. ABC accounts for the contract modification under either the return approach or the prospective approach discussed in Question G131.

Return approach

ABC reverses the full amount of the contract asset associated with the revoked license to product T because that reversal results in ABC recognizing revenue for SaaS equal to observable stand-alone selling price.

As a result of the modification, ABC records the following entry at the beginning of Year 2.

	Debit	*Credit*
Cash	320,000	
License revenue[1]	400,000	
Contract asset		400,000
Contract liability		320,000
To recognize effect of modification.		

Note:

1. Because the SaaS subscription is being sold at its observable stand-alone selling price, the entire existing $400,000 contract asset is determined to be attributable to the revoked product T license rights.

ABC will recognize $320,000 in SaaS revenue in each of Years 2 and 3.

Prospective approach

ABC does not reverse any amounts associated with the revoked license or adjust the existing contract asset. To prospectively account for the modification, ABC records the following entry in each of Years 2 and 3:

	Debit	*Credit*
Cash	320,000	
Contract asset		200,000
SaaS Revenue		120,000
To recognize payment received and SaaS revenue on a prospective basis		

Question G132

What is the appropriate accounting for a modification granting the customer the right to convert a software license to SaaS?

Background: Question G131 addresses when a contract is modified to convert a customer's on-premise software license to SaaS. Similarly, Question C85 addresses contracts that grant the customer a right to convert an on-premise software license to SaaS at inception.

This question addresses the related scenario in which a contract is modified to grant the customer the *option* (or right) to convert its license to SaaS when that option was not implicit in the contract pre-modification. Just like when a conversion option exists at contract inception, the customer may or may not exercise that option.

If the customer immediately exercises its option upon modification, we believe the accounting would be similar to that outlined in Question G131.

Interpretive response: If the conversion price would increase the contract price by an amount greater than or commensurate with the stand-alone selling price of the SaaS, the customer would pay a substantive amount for both the software license and the SaaS, if converted. As such, the conversion right is effectively just a marketing offer that does not change the scope or pricing of the existing contract. Consequently, there is no contract modification when the option is granted. If the customer exercises that option, the SaaS arrangement would be accounted for as a separate contract. [606-10-25-12, 55-43]

In contrast, adding a SaaS conversion option that is not solely a marketing offer is a contract modification that changes the scope and/or price of the contract. As outlined in Question C85, we believe there are two acceptable approaches to account for a SaaS conversion option; to account for the option either as (1) a right of return on the software license that can be converted, or (2) a material right to the discounted SaaS. Question C85 outlines why we believe both approaches are currently acceptable.

Like Question G131, this question presumes that the addition of the SaaS conversion option is the only change in the modified contract. If other changes are also made to the contract, those changes may affect the accounting for the modification. For example, other changes to the contract other than adding the SaaS conversion option may require a cumulative revenue adjustment.

Right of return approach

Under the right of return approach, the added right of return reduces the transaction price because rights of return are accounted for as variable consideration. Assuming no other changes to the transaction price from the modification, which may not always be the case, recording the required refund liability will trigger a reversal of revenue at the modification date.

The refund liability would be adjusted until the conversion right is exercised or expires.

Material right approach

Under a material right approach, because all material rights are separate performance obligations, the material right is distinct from the previously satisfied performance obligations. Therefore, the contract modification would be accounted for either: [606-10-55-42]

- prospectively, as a termination of the old contract and creation of a new one, if all the other remaining goods and services post-modification are distinct from the previously transferred goods and services; or
- with prospective and cumulative effect if there are remaining performance obligations post-modification that are not distinct from goods or services transferred (or partially transferred) pre-modification (see Question G150).

In many scenarios, the only remaining pre-modification performance obligation is PCS. Therefore, a modification that adds a SaaS conversation right will be accounted for prospectively, consistent with the first bullet. For those modifications, any previously recognized revenue is not adjusted. The remaining, unrecognized consideration from the original contract and the additional consideration added by the modification, net of any existing contract asset (see Question G100), is allocated to the remaining goods and services to be provided under the modified contract (e.g. the remaining PCS and new material right).

The entity then accounts for the material right in a manner consistent with the accounting for any other material right, which includes deferring the amount allocated to the material right until either (1) it is exercised and the underlying goods and services are transferred or (2) it expires.

Question G140

Can an entity recognize license revenue for a period that extends beyond the original license term before the beginning of the extended period if the entity and the customer terminate the original license and enter into a 'new' license that includes the remainder of the original term plus the extension period?

Interpretive response: No. Topic 606 contains an explicit requirement to recognize revenue attributable to the extension or renewal of a term license no sooner than the beginning of the extension or renewal period (see Question F100). This requirement applies regardless of whether the extension or renewal is structured as an extension or renewal or as a termination of the original license and creation of a new license. That is, whatever rights of use are *retained* by the customer and extended as to duration after the 'termination' would remain subject to the renewal recognition requirements in paragraph 606-10-55-58C; therefore, whatever portion of the modified transaction price relates to the extension or renewal period rights cannot be recognized until the extension or renewal period commences.

A license to intellectual property (including software) is a contracted bundle of rights to use or access that intellectual property. Therefore, in conjunction with a contract modification that 'terminated' the original software license, new rights to use that software may be granted to the customer it did not control before the modification. For example, the modification may permit the customer to use the entity's software for an additional purpose. In that case, the portion of the post-modification transaction price allocated to those additional rights (i.e. the additional license granting the customer incremental rights to use the entity's software) is recognized when the customer obtains control over those incremental rights (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*).

Example G140.1

Term software license terminated and new license with same rights entered into

Scenario 1

On January 1, 20X4, ABC Corp. and Customer entered into a three-year license of ABC's software Product H that commenced immediately. There were no other promised goods or services in the contract. The contract price was $300, paid upfront. ABC transferred control of the license on January 1, 20X4.

On January 1, 20X6, ABC and Customer enter into an amendment of their license agreement, which immediately terminates the original three-year license and grants a new four-year license to the same software product. No other goods or services are added to the arrangement through the amendment. Other than the extension of the term, the customer's rights to use the software are unchanged between the original license and the new license. The fee for the new license is $300, payable at the time the amendment is entered into.

In substance, the original license is not terminated in this example; Customer retains the same rights to use Product H post-modification as it had pre-modification. Therefore, the modification adds a distinct three-year renewal license that commences on January 1, 20X7 – i.e. subsequent to the end of the original license period.

Because there are no other promised goods or services in the new, separate contract, $300 in revenue is recognized when Customer obtains control of the three-year renewal license, which, in accordance with paragraph 606-10-55-58C, is the beginning of the renewal term (i.e. January 1, 20X7) – see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*). Even though Customer pays for the renewal license in advance of obtaining control of that license, ABC does not need to consider whether there is a significant financing component resulting from the advance payment because the period of time between payment and transfer of the license is one year or less. If that period of time were greater than one year, ABC would have to consider whether the advance payment of the license fee creates a significant financing component.

Scenario 2

Assume the same facts as in Scenario 1 except that the amendment terminates the original three-year software license and grants a new *perpetual* license to software Product H.

Consistent with Scenario 1, the original license is not terminated in this example; Customer retains the same rights to use Product H post-modification as it had pre-modification. Therefore, the modification adds a distinct perpetual license that commences on January 1, 20X7 – i.e. subsequent to the end of the original three-year license period.

The remainder of the accounting in this scenario follows that for Scenario 1, ABC recognizes the $300 in consideration attributable to the perpetual software license on January 1, 20X7, which is the beginning of the perpetual license period. This result is also consistent with the discussion in Question C440 about a customer's exercise of an option to convert a term license to a perpetual license.

Scenario 3

Assume the same facts as in Scenario 1 except that:

- the license fee for the original license is paid over time, annually in advance (i.e. $100 per year in advance, rather than $300 upfront);
- the modification is entered into before Customer makes its final $100 (Year 3) payment for the Product H license; and
- the fees in the amendment are $400, paid annually in advance over the next four years, beginning on January 1, 20X6 (i.e. the modification date).

Note that for purposes of this scenario, the entity concludes that there is not a significant financing component resulting from the license fees being paid over time.

The extended payment terms do not change the substance of the arrangement from that described in Scenario 1. The $100 payment made on January 1, 20X6 reduces the contract asset associated with the original license to zero. The remainder of the accounting for the modification is consistent with that outlined for the separate contract in Scenario 1 – i.e. the $300 in remaining consideration is recognized as revenue when Customer obtains control of the three-year renewal license, which, in accordance with paragraph 606-10-55-58C, is the beginning of the renewal term (i.e. January 1, 20X7).

Example G140.2

Term software license terminated and new rights of use granted

On January 1, 20X4, ABC Corp. and Customer entered into a three-year license of ABC's software Product H that commenced immediately. The license permits Customer to embed Product H into Customer's high-end kitchen appliances. There were no other promised goods or services in the contract. The contract price was $300, paid upfront. ABC transferred control of the license on January 1, 20X4.

On January 1, 20X6, ABC and Customer enter into an amendment of their license agreement, which immediately terminates the original three-year license and grants Customer both (1) the continued right to embed Product H into Customer's high-end kitchen appliances for four years and (2) a new right to embed Product H in its personal electronics for four years. Customer already has a copy of Product H and is permitted to exercise both rights immediately upon execution of the amendment. Customer agrees to pay $800 upon execution of the amendment.

ABC concludes that there are two promised goods or services subsequent to executing the amendment:

— a three-year renewal license for Customer to embed Product H in its high-end kitchen appliances; and
— a four-year license for Customer to embed Product H in its personal electronics products.

ABC further concludes that those two licenses are distinct from each other and, therefore, separate performance obligations. Customer can benefit from each license on its own and the promise to transfer each license is separately identifiable – i.e. neither license customizes or modifies the other, ABC can transfer each license independently of the other, and the two licenses do not provide a combined functionality or utility that suggests ABC is providing a combined output comprised of the two licenses.

Consistent with Example G140.1, the termination of the original three-year license to Product H is not substantive; therefore, it is not considered in determining the promised goods and services to be provided to Customer subsequent to the contract amendment.

There is no remaining, unrecognized consideration from the original contract. Therefore, the amount of consideration to be allocated to the remaining performance obligations (i.e. the two distinct licenses) is the $800 promised in the amendment. Regardless of the amount allocated to each license, the portion allocated to the three-year renewal license is recognized at the beginning of the renewal license term (i.e. January 1, 20X7), while the portion allocated to the new four-year license will be recognized on January 1, 20X6 – i.e. when Customer has obtained control over its right to use the software in its personal electronics products.

Question G150

How should an entity account for modifications that include some goods or services that are distinct from those provided pre-modification and some that are not distinct?

Interpretive response: A contract modification in which the criteria in paragraph 606-10-25-12 are not met may include a combination of goods or services that are distinct from those provided on or before the modification date and some that are not distinct. That is, the remaining goods or services may be a combination of items that, independently, would fall under the guidance in paragraphs 606-10-25-13(a) and 606-10-25-13(b). In those circumstances, the guidance requires an entity to account for the effects of the modification on the unsatisfied (including partially satisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of the modification guidance. However, Topic 606 does not provide guidance on how to determine and allocate the remaining consideration in a contract modification of this type.

We believe one acceptable approach would be to first calculate the remaining consideration, using the approach in paragraph 606-10-25-13(a), which is outlined in the overview of this chapter, and allocate that consideration to the remaining goods or services using the general Step 4 allocation model. *After* that, the entity would recognize a cumulative catch-up adjustment to a performance obligation that, post-modification, includes goods or services from the original contract and goods or services added by the modification. The cumulative catch-up adjustment would generally apply an updated measure of progress to the sum of (1) the remaining consideration allocated to the partially satisfied performance obligation and (2) the revenue already recognized on that performance obligation.

The entity would account for the goods or services added by the modification that are distinct from the goods or services provided on or before the date of the modification as separate performance obligations.

Revenue recognized for transferred goods or services (i.e. fully satisfied goods or services) that are distinct from the remaining performance obligations is not altered by the modification. We believe that any approach that results in the reversal of previously recognized revenue associated with a transferred good or service that is distinct (e.g. a software license for which control had previously transferred or distinct services, such as hosting services or SaaS, already provided as part of a single performance obligation that is a series of distinct service periods) from the remaining goods or services would not be consistent with the objectives of the modification guidance.

Example G150.1

Partially satisfied performance obligation and additional distinct goods or services (combination of methods)

ABC Corp. enters into a contract with Customer for a perpetual software license to Product Z and for significant services to customize Product Z for Customer's needs. The consideration for the license and the customization services is $1,000,000. Company A has determined that the license and the customization services are a single performance obligation (see Question C230) and that revenue should be recognized over time (see Question F200) using a cost-to-cost measure of progress toward complete satisfaction of the performance obligation.

At the end of Year 1 of the anticipated two-year performance period, ABC has satisfied 30% of the performance obligation. Therefore, ABC has recognized $300,000 of revenue up to the end of Year 1.

At the beginning of Year 2, the parties agree to change some of the customizations for Product Z and increase the consideration by $100,000.

Additionally, ABC agrees with Customer to transfer a perpetual license to software Product X for $120,000.

The license to Product X is distinct from the combined Product Z software customization performance obligation. The price of the Product X license is significantly discounted from its stand-alone selling price of $150,000, and that discount is not the result of adjustments that are 'appropriate' to the circumstances of this contract (see Questions G70 and G90).

Because the price of the Product X license does not reflect its stand-alone selling price and the discount from that stand-alone selling price is not the result of adjustments that are appropriate to the circumstances of the contract, the Product X license cannot be accounted for as a separate contract. Therefore, both the Product Z performance obligation and the distinct Product X license are considered part of the same contract when accounting for the modification.

ABC accounts for the modification as follows.

Step (i) – Calculate the remaining consideration

Remaining consideration on original contract not yet recognized as revenue	$700,000
Change order	100,000
Product X license	120,000
Total remaining consideration	**$920,000**

Step (ii) – Allocate the remaining consideration between the Product Z combined performance obligation and the performance obligation to transfer a license to Product X

The remaining consideration of $920,000 is allocated to the Product Z performance obligation and the Product X license as follows (see *Chapter E – Step 4: Allocate the transaction price to the performance obligations in the contract*).

	Stand-alone selling prices	Percent allocated	Allocated amounts
Remaining for Product Z software customization	$ 900,000	85.7%	$788,571
Product X license	150,000	14.3%	131,429
Total	**$1,050,000**		**$920,000**

Step (iii) – Record a cumulative catch-up adjustment for the partially satisfied performance obligation

For the partially satisfied performance obligation (Product Z software customization), ABC accounts for the contract modification as part of the original contract. Therefore, ABC updates its measure of progress and estimates that it has satisfied 27.4% of its performance obligation after revising its cost-to-cost measure of progress for the revised expected costs. As a consequence, ABC records the following adjustment, which reduces revenue previously recognized:

> *$1,732 = (27.4% complete × $1,088,571 [$300,000 + $788,571] modified transaction price allocable to Product Z) – $300,000 revenue recognized to date.*

When ABC transfers control of the license to software Product X it recognizes revenue in the amount of $131,429.

Example G150.2

Partially satisfied performance obligation and additional distinct software license (combination of methods)

ABC Corp. sells a license to software Product A along with PCS (co-terminus technical support and unspecified update, upgrade and enhancement rights accounted for as a single performance obligation – see Question C150) for three years and consulting services to Customer beginning on January 1, 20X6. The stated consideration for the software license is $300,000. Stated consideration for the PCS and the consulting services are $30,000 and $10,000, respectively. The stated prices are commensurate with the stand-alone selling prices of the items.

The terms of the license permit Customer to have 10 named users. ABC makes available to Customer a copy of the software and Customer's rights to use the software commence on January 1, 20X6. ABC concludes that the software license, PCS and consulting services are each distinct from the others and, therefore, separate performance obligations. ABC has determined that revenue related to the consulting services should be recognized over time using the cost-to-cost input method. PCS qualifies as a series in accordance with paragraph 606-10-25-14(b), and the consideration is recognized using a time-elapsed measure of progress over the three-year PCS term.

At the end of Year 1, ABC has satisfied 30% of its performance obligation related to the consulting services, therefore ABC has recognized $3,000 of revenue up to the end of Year 1. In addition, ABC has recognized $10,000 of revenue related to PCS up to the end of Year 1. ABC recognized the $300,000 of revenue related to the Product A license on January 1, 20X6.

At the beginning of Year 2, the parties agree to amend the license agreement to permit Customer up to 20 named users (an increase from the right to 10 named users granted on January 1, 20X6) for an additional fee of $100,000 for the additional named users and $10,000 for incremental PCS for the remaining two years of the existing PCS term. In addition, the parties agree to expand the scope of the consulting services for additional consideration of $5,000.

ABC concludes that the incremental right to use Product A (i.e. an additional 10 named user license) is distinct from the original 10 named user license, but concludes that the expanded consulting services are *not* distinct from the consulting services provided under the original contract before the modification.

ABC next concludes that the $110,000 in additional consideration for the additional license and incremental PCS do not reflect the stand-alone selling price of those items. As such, the additional software license and the incremental PCS are not accounted for as a separate contract.

ABC then concludes that in this arrangement, the additional license and the remaining two years of PCS (the original and additional license PCS are accounted for as a single performance obligation because they are co-terminus and have the same time-based pattern of transfer to the customer) are separate performance obligations that would typically be accounted for prospectively in accordance with paragraph 606-10-25-13(a). Meanwhile, the expansion of the consulting services represents a change in scope of a partially satisfied performance obligation; the incremental services to be provided to fulfill the expanded scope are not distinct from the previously provided services. This portion of the modified arrangements would typically be accounted on a cumulative catch-up basis in accordance with paragraph 606-10-25-13(b).

However, because the modification incorporates scenarios that would be accounted for in accordance with both paragraphs 606-10-25-13(a) and (b), ABC accounts for the modification in accordance with paragraph 606-10-25-13(c).

Step (i) – Calculate the remaining consideration.

Consideration in original contract not yet recognized as revenue (PCS)	$ 20,000
Consideration in original contract not yet recognized as revenue (consulting services)	7,000
Additional 10 user license	100,000
PCS for the additional 10 user license	10,000
Consideration for expanded consulting	5,000
Total remaining consideration	**$142,000**

Step (ii) – Allocate the remaining consideration between PCS, consulting services and the license for the additional 10 users in accordance with the allocation guidance in Step 4 of the model.

	Stand-alone selling price	Percent allocated	Allocated amounts
Remaining for initial PCS	$ 20,000	7.9%	$ 11,218
PCS for 10 additional users	20,000	7.9%	11,218
License for an additional 10 users for two years	200,000	79.1%	112,322
Remaining consulting services	13,000	5.1%	7,242
Total	**$253,000**	**100.0%**	**$142,000**

Step (iii) – Record a cumulative catch-up adjustment for the partially satisfied performance obligation.

For the partially satisfied performance obligation (consulting services), ABC accounts for the contract modification as part of the original contract. ABC updates its measure of progress and estimates that it has satisfied 27.4% of its performance obligation and calculates the following cumulative catch-up adjustment, which reduces revenue by $194, calculated as follows:

> *$194 = (27.4% × $10,242 [$3,000 + $7,242] modified transaction price allocable to the consulting services) – $3,000 revenue recognized to date.*

The revenue allocated to the license for an additional 10 users ($112,322) is recognized by ABC at the point in time Customer obtains control of the license – i.e. when it can begin to use and benefit from the additional 10-named user rights.

The revenue allocated to the remaining and incremental PCS ($22,436 in aggregate) will be recognized over the remaining two-year remaining PCS period as ABC satisfies the remaining performance obligation.

Question G160

In the case of an unpriced change order that has been determined to constitute a contract modification, is the expected payment that has not yet been approved variable consideration?

Interpretive response: Yes. Until the parties agree on the price for the change order, the estimated fees are considered variable consideration. Once an unpriced change order is determined to be a contract modification (see Question G20), the entity estimates the variable consideration to which it expects to be entitled, subject to the constraint on variable consideration. The entity will then apply the constraint on variable consideration to determine the updated transaction price. In applying the constraint on variable consideration to a contract modification, the entity could consider the following (derived from the factors an entity would use in applying the constraint on variable consideration – see *Chapter D – Step 3: Determine the transaction price*):

- whether there is expected to be a lengthy period of time before the amount of consideration to be paid relative to the change order can or will be determined;
- whether there are numerous factors that could affect the amount of consideration to which the entity would be entitled, and whether those factors are substantially in the control of the entity (e.g. does the entity control the timeline to complete the change order where the amount of consideration to which it will be entitled is dependent thereon); and/or
- whether the consideration to be paid for completing the change order is objectively determinable from the framework in a master services agreement or other governing document, rather than subjective (e.g. based largely on the success of a subsequent negotiation). If the entity is unable to support an expectation of payment by the customer for the change order, there would not be a contract modification until such time as there was an expectation of payment.

In circumstances where there is an expectation of payment and the estimated fees are constrained, but the entity expects to recover its costs to fulfill the change order, the entity should include the amount of the costs it expects to recover from additional variable consideration as additional transaction price resulting from the contract modification (i.e. a zero profit margin). The entity would update the transaction price as it has more information about the amount of variable consideration.

Example G160.1

Accounting for a contract modification resulting from an unpriced change order

ABC Corp. enters into a contract with Customer for a perpetual software license to Product Z and for significant services to customize Product Z for Customer's needs. The consideration for the license and the customization services is $1,000,000. Company A has determined that the license and the customization services are a single performance obligation (see Question C230) and that revenue should be recognized over time (see Question F200) using a cost-to-cost measure of progress toward complete satisfaction of the performance obligation. At inception, Company A expects the following.

Transaction price	$1,000,000
Expected costs	800,000
Expected profit (20%)	**$ 200,000**

After 15 months of the project, Customer requests that ABC make a complex change to the planned customizations, and ABC concludes that the change to the customizations is not distinct from the combined software customization performance obligation in the original contract. ABC agrees and begins the work immediately, which it expects to complete within five-six months (original project plan called for completion of the project in 18 months). However, the additional transaction price to be paid for the change will be negotiated subsequently. ABC expects that it will get paid for the incremental efforts, and therefore, concludes that the contract has been modified. At the date of modification, ABC has incurred $600,000 of the estimated $800,000 in costs to be incurred in completing the software customization project (i.e. the project is 75% complete), and therefore, has recognized the following.

Revenue	$750,000
Costs	600,000
Gross profit	**$150,000**

ABC estimates that the change order will increase total costs by $200,000 and expects that it will be entitled to additional fees of $300,000 based on the complex nature of the changes being requested. ABC uses a most likely approach to estimate the transaction price and believes that it has sufficient experience in fulfilling complex change orders on similar contracts. Company A believes that its experience is relevant and predictive because it is largely within its control whether it completes the project and does so timely, and because it believes the master services agreement provides a reasonable basis from which to negotiate the change order consideration without a wide range of subjectivity. In addition, the period of time to complete the order is not lengthy in comparison to ABC's typical projects or other change orders. Despite the fact that ABC is confident in its estimate of $300,000, ABC concludes that there is no more than a remote chance that it won't be entitled to *at least* $240,000 for the change order, consistent with the 20% profit margin expected in the original contract. ABC considers whether it must constrain its most likely $300,000 estimate to $240,000. ABC concludes that because $60,000 ($300,000 – $240,000) is only 4.6% of the total contract price and that $60,000 will be recognized over time (i.e. over the five-six months remaining in the project), the potential cumulative revenue reversal that would result would not be significant (see Question D180).

Therefore, based on the quality of its estimate, and the fact that any potential cumulative revenue reversal would not be significant, ABC does not constrain its most likely estimate of $300,000 and adds that amount to the transaction price for the contract.

Based on the revised estimate of costs, ABC adjusts its measure of progress to 60% ($600,000 incurred costs as compared to $1,000,000 total expected costs). As a result, the cumulative revenue and costs to be recognized at the date of the contract modification is as follows.

Revenue[1]	$780,000
Costs	600,000
Gross profit	**$180,000**

Note:

1. ($1,300,000 × [$600,000/$1,000,000]).

Therefore, at the date of modification, Company A would record an additional $30,000 in contract revenue ($780,000 – $750,000 previously recognized = $30,000). Company A would record the remaining $520,000 in contract revenue ($1,300,000 total transaction price – $780,000 recognized = $520,000) as the software customization is completed.

H. Contract costs

Questions and Examples

Scope

Costs of obtaining a contract

Q&A H110	Is a commission paid only after achieving a cumulative target an incremental cost of obtaining a contract, and when would it be recognized as an asset?
	Example H110.1: Commission plan with tiered thresholds – cumulative effect
	Example H110.2: Commission plan with tiered thresholds – prospective effect
Q&A H120	If an entity pays commissions to personnel other than the salesperson (e.g. a sales manager or sales support staff), are those commissions capitalized (if recoverable)?
Q&A H130	Should an entity capitalize commissions earned on contract modifications that are not treated as separate contracts?
	Example H130.1: Commission paid upon contract modification
Q&A H140	Should an entity capitalize commissions paid to obtain contract renewals?
Q&A H150	Can the practical expedient apply to renewals of a contract, but not the initial contract?
Q&A H160	Can an entity apply the costs to obtain a contract practical expedient if only one or some (but not all) of the goods or services to which the contract acquisition costs relate will be satisfied in one year or less?
Q&A H170	Can the practical expedient for expensing costs to obtain a contract as incurred be applied to commissions for which the amortization period, if capitalized, would be only slightly greater than one year?
	Example H170.1: Practical expedient when amortization period is slightly longer than one year
Q&A H180	Are anticipated contracts (e.g. contract renewals) included when determining whether the practical expedient applies?
Q&A H190	What is the accounting if an entity applies the practical expedient not to capitalize costs to obtain a contract but subsequently determines that the amortization period is greater than one year?
Q&A H200	What should an entity consider with respect to fees paid to a third party used to generate sales and provide implementation services when applying the guidance in Subtopic 340-40?

Costs of fulfilling a contract

Q&A H210	Can entities capitalize fulfillment costs incurred before approval of the related contract (i.e. pre-contract costs)?
	Example H210.1: Contract fulfillment costs in a specifically anticipated service contract
Q&A H220	Are costs related to fulfilling set-up activities capitalized under Subtopic 340-40?

Amortization and impairment of contract cost assets

This chapter is organized into four sections:

— Scope
— Costs of obtaining a contract
— Costs of fulfilling a contract
— Amortization and impairment of contract cost assets

Scope

Overview

Excerpt from ASC 606-10

> Transactions

15-5 Subtopic 340-40 on other assets and deferred costs from contracts with customers includes guidance on accounting for the incremental costs of obtaining a contract with a customer and for the costs incurred to fulfill a contract with a customer if those costs are not within the scope of another Topic (see Subtopic 340-40). An entity shall apply that guidance only to the costs incurred that relate to a contract with a customer (or part of that contract) that is within the scope of the guidance in this Topic.

Excerpt from ASC 340-40

05-1 This Subtopic provides accounting guidance for the following costs related to a **contract** with a **customer** within the scope of Topic 606 on **revenue** from contracts with customers:

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

05-2 Paragraphs presented in **bold type** in this Subtopic state the main principles. All paragraphs have equal authority.

> Overall Guidance

15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic (see Section 340-10-15), with specific qualifications and exceptions noted below.

> Transactions

>> Incremental Costs of Obtaining a Contract with a Customer

15-2 The guidance in this Subtopic applies to the incremental costs of obtaining a **contract** with a **customer** within the scope of Topic 606 on **revenue** from contracts with customers (excluding any consideration payable to a customer, see paragraphs 606-10-32-25 through 32-27).

>> Costs Incurred in Fulfilling a Contract with a Customer

15-3 The guidance in this Subtopic applies to the costs incurred in fulfilling a **contract** with a **customer** within the scope of Topic 606 on **revenue** from contracts with customers, unless the costs are within the scope of another Topic or Subtopic, including, but not limited to, any of the following:

a. Topic 330 on inventory
b. Paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements
c. Subtopic 350-40 on internal-use software
d. Topic 360 on property, plant, and equipment

Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed.

Excerpt from ASC 985-20

> Transactions

15-3 The guidance in this Subtopic does not apply to the following transactions and activities:

a. Software developed or obtained for internal use (see Subtopic 350-40) or for others under a contractual arrangement (see Subtopic 605-35).
b. Research and development assets acquired in a business combination or an **acquisition by a not-for-profit entity**. If tangible and intangible assets acquired in those combinations are used in research and development activities, they are recognized and measured at fair value in accordance with Subtopic 805-20.
c. Arrangements to deliver software or a software system, either alone or together with other products or services, requiring significant production, modification, or customization of software (see the guidance on costs to fulfill a contract in Subtopic 340-40).

Subtopic 340-40 does not provide comprehensive guidance on the accounting for contract costs. In many cases, entities continue to apply existing cost guidance (e.g. guidance on inventory or property, plant and equipment). However, the new standard added Subtopic 340-40 to apply to certain costs incurred in relation to contracts with customers.

Subsequent measurement

Amortization of assets arising from costs to obtain or fulfill a contract	Impairment of assets arising from costs to obtain or fulfill a contract

Subtopic 340-40 is intended to (a) fill the gap in contract costs guidance arising from the withdrawal of existing revenue standards (e.g. construction-type contracts in Subtopic 605-35), (b) improve practice and promote consistency in certain areas by providing clearer guidance (e.g. set-up costs that, under legacy US GAAP, are either expensed as incurred or deferred by analogy to guidance not developed for those types of costs), and (c) promote additional convergence between US GAAP and IFRS. However, substantial convergence in cost accounting between US GAAP and IFRS would require a more significant undertaking to align US GAAP and IFRS guidance on topics such as inventory, property, plant and equipment, intangible assets, and impairment of those assets.

The cost guidance in Subtopic 340-40 prescribes accounting only for incremental costs to obtain a contract and certain costs to fulfill a contract not in the scope of other US GAAP. Consequently, if other US GAAP precludes or requires recognition of an asset arising from a particular cost, that guidance is followed instead of Subtopic 340-40. For example, Subtopic 340-40 does not amend the current guidance on accounting for (not all-inclusive):

Type of cost	Authoritative literature
Credit-card related costs	Subtopic 310-10, Receivables – Overall Subtopic 310-20, Receivables – Nonrefundable Fees and Other Costs
Inventory costs	Topic 330, Inventory
Production costs related to long-term supply arrangements	Subtopic 340-10, Other Assets and Deferred Costs—Overall
Intangible assets, including internal-use software development costs and website development costs	Topic 350, Intangibles – Goodwill and Other
Costs of property, plant and equipment	Topic 360, Property, Plant, and Equipment
Start-up costs	Subtopic 720-15, Other Expenses – Start-Up Costs
Advertising costs	Subtopic 720-35, Advertising Costs
Research and development costs	Topic 730, Research and Development
Cable television initial subscriber installation costs and reconnection costs	Subtopic 922-360, Entertainment — Cable Television — Property, Plant, and Equipment

Type of cost	Authoritative literature
	Subtopic 922-720, Entertainment — Cable Television — Other Expenses
Film costs	Subtopic 926-20, Entertainment – Films, Other Assets – Film Costs
Insurance acquisition costs	Topic 944, Financial Services – Insurance
Upfront commissions paid to third-party brokers who distribute fund shares to investors	Paragraph 946-720, Other Expenses – Distribution Costs for Funds
Real estate project costs	Topic 970, Real Estate – General
External-use software development costs	Subtopic 985-20, Software – Costs of Software to be Sold, Leased, or Marketed

Questions & answers

Question H10

Can an entity apply the portfolio approach when evaluating contract costs under Subtopic 340-40?

Interpretive response: Topic 606 and Subtopic 340-40 are both generally applied to an individual contract with a customer. However, Topic 606 includes a practical expedient (paragraph 606-10-10-4) that permits an entity to apply the revenue model to a portfolio of contracts with similar characteristics if the entity reasonably expects that the financial statement effects of applying Topic 606 to that portfolio would not differ materially from applying it to the individual contracts within that portfolio. Even though Subtopic 340-40 does not include a similar provision, the practical expedient is available for costs in the scope of Subtopic 340-40.

Topic 606 does not provide specific guidance on how an entity assesses whether the results of a portfolio approach would differ materially from applying the new guidance on a contract-by-contract basis. However, the Basis for Conclusions to ASU 2014-09 (BC69) notes that the Boards did not intend for entities, in order to use the portfolio approach, to have to quantitatively evaluate the accounting outcomes from applying a portfolio approach and not applying a portfolio approach.

In some circumstances when applying Topic 606 or Subtopic 340-40, an entity will develop estimates using a 'portfolio of data' to account for a specific contract with a customer. For example, entities may use historical data from a population of similar contracts to develop estimates relevant to accounting for contract costs in accordance with Subtopic 340-40 (e.g. estimates about expected customer lives or collectibility – collectibility affects the "amount of consideration that the entity expects to receive" when assessing impairment of contract cost assets). The use of a portfolio of data to develop estimates required to apply the guidance in Subtopic 340-40 is not the same as applying the portfolio approach. When using a portfolio of data to develop relevant accounting estimates (as opposed to using a portfolio approach), there is no requirement to demonstrate that the effect of using that portfolio of data would not differ materially from developing the estimate on a customer- or contract-specific basis.

Question H20

If another Topic specifies that a cost is not capitalizable, does an entity then consider whether it is a capitalizable cost to obtain or to fulfill a contract in accordance with Subtopic 340-40?

Interpretive response: No. Subtopic 340-40 only applies to contract costs that are not addressed by other Topics. If another Topic requires a cost to be expensed as incurred (e.g. research and development costs within the scope of Topic 730), it is not then additionally considered for capitalization under Subtopic 340-40. Consequently, such costs are expensed as incurred in accordance with Topic 730 and they are not evaluated for capitalization under Subtopic 340-40 even if they were to meet the fulfillment cost capitalization criteria in paragraph 340-40-25-5.

Excerpt from ASU 2014-09

BC307. Because the Boards decided not to reconsider all cost guidance comprehensively, paragraphs 340-40-25-1 through 25-8 specify the accounting for contract costs that are not within the scope of other Topics. Consequently, if the other Topics preclude the recognition of any asset arising from a particular cost, an asset cannot then be recognized under Subtopic 340-40 (for example, in U.S. GAAP, pre-production costs under long-term supply arrangements will continue to be accounted for in accordance with paragraphs 340-10-25-5 through 25-8, and in IFRS, initial operating losses, such as those incurred while demand for an item builds, will continue to be accounted for in accordance with paragraph 20(b) of IAS 16).

Question H30

Does Subtopic 340-40 apply to software development costs?

Interpretive response: It depends. Software development costs that are in the scope of either Subtopic 985-20, *Software – Costs of Software to Be Sold, Leased, or Marketed*, or Subtopic 350-40, *Internal-Use Software* are accounted for in accordance with that guidance, and are outside the scope of Subtopic 340-40. This is because Subtopic 340-40 only applies to costs that are not in the scope of another Topic, such as Subtopic 985-20 or Subtopic 350-40. Chapter 2 of KPMG Handbook, Software and website costs discusses the scope of Subtopics 985-20 and 350-40. [340-40-15-3, 606-10-15-5]

Contracts to develop software for others under a contractual arrangement are excluded from Subtopic 985-20 and Subtopic 350-40. Those contractual arrangements with customers are subject to Topic 606 and the entity generally applies Subtopic 340-40 to the costs to fulfill the revenue contract. However, before entering into the contract with a customer, Subtopic 340-40 would not apply if the development costs would otherwise be accounted for under Subtopic 985-20 or Subtopic 350-40. [350-40-15-4(c), 985-20-15-3(c)]

When the development costs are in the scope of Subtopic 340-40 and the performance obligation to develop the software is satisfied over time, the development costs will not be capitalizable under Subtopic 340-40 because they relate to past performance (the partially satisfied customized software development performance obligation). When the development costs are in the scope of Subtopic 340-40 and the performance obligation to develop software is not satisfied over time, the development costs may be capitalizable (see Questions H210 – H230 for further discussion on capitalizing contract fulfillment costs).

Example 2.3.10 of KPMG Handbook, Software and website costs, provides examples of software development costs that are outside the scope of Subtopics 985-20 or 350-40, and in the scope of Subtopic 340-40.

Example H30.1

Costs incurred to fulfill a software development contract

ABC Corp. contracts with Customer to develop a customized software application that will assist Customer in managing its worldwide operations. ABC determines that the performance obligation is not satisfied over time due to customer-specific acceptance provisions that ABC does not have relevant history of meeting (see Question F210).

Because the customized software is being developed pursuant to a customer contract, it is not in the scope of Subtopic 985-20, nor is the software within the scope of Subtopic 350-40 because it will be sold to a specific customer. Therefore, ABC considers the fulfillment cost guidance in Subtopic 340-40. Because the costs relate directly to the software development contract with Customer, generate resources (the software) ABC will use to satisfy its performance obligation to transfer that software to Customer, and are expected to be recovered (even if the contract is terminated), ABC capitalizes the contract costs it incurs fulfilling this contract with Customer. In accordance with paragraph 340-40-35-1, ABC will derecognize such costs at the point in time it transfers control of the completed software to Customer.

Example H30.2

Development costs incurred in a SaaS arrangement

ABC Corp. contracts with Customer to provide access to its hosted software application on a SaaS basis (i.e. Customer does not have the right to take possession of the software, and therefore there is no software license in the contract) for three years. As part of the contract with Customer, ABC agrees to develop an additional functionality for its hosted application that it will introduce into the multi-tenant environment before Customer 'goes live'. It is expected it will take ABC four-six months to complete and install the upgraded software (i.e. with the additional Customer-requested functionality). Once the upgraded software is implemented into the multi-tenant environment, all of ABC's customers in that environment will have access to the additional functionality.

ABC concludes that the fundamental nature of its performance obligation to Customer is three years' access to the SaaS offering (enhanced for the additional functionality requested by Customer), which is a performance obligation satisfied over time because Customer will consume and receive benefit from that access as such access is provided over the SaaS period. ABC further concludes that the best single measure of progress toward complete satisfaction of that performance obligation is a time-elapsed output measure, reflective of the generally equal value the customer will get from access to the SaaS offering during the three-year period. Other measures of progress, such as a cost-to-cost measure, are determined not to be appropriate because ABC will incur most of its incremental costs during the relatively short development period. Based on this measure of progress, no revenue is recognized during the development period because Customer does not receive any benefit until it obtains access to the SaaS offering after development is complete.

ABC incurs $100,000 in development and other direct costs (e.g. additional coding and testing of the enhanced software) to develop the additional functionality requested by Customer. ABC concludes that those costs are within the scope of Subtopic 350-40 on internal-use software. Consequently, ABC follows the guidance in Subtopic 350-40 in accounting for those costs.

Costs of obtaining a contract

Overview

Excerpt from ASC 340-40

>> Incremental Costs of Obtaining a Contract

25-1 An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

25-2 The incremental costs of obtaining a contract are those that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

25-3 Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

25-4 As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

>>> Example 1—Incremental Costs of Obtaining a Contract

55-2 An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new **customer**. The entity incurred the following costs to obtain the contract:

External legal fees for due diligence	$15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	10,000
Total costs incurred	$50,000

55-3 In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity, and individual performance evaluations. In accordance with paragraph 340-40-25-1, the entity does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.

55-4 The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 340-40-25-3, those costs are recognized as expenses when incurred, unless they are within the scope of another Topic, in which case, the guidance in that Topic applies.

>>> Example 2—Costs That Give Rise to an Asset

55-5 An entity enters into a service contract to manage a customer's information technology data center for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity pays an employee a $10,000 sales commission upon the customer signing the contract. Before providing the services, the entity designs and builds a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer but will be used to deliver services to the customer.

>>>> Incremental Costs of Obtaining a Contract

55-6 In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract for the sales commission because the entity expects to recover those costs through future fees for the services to be provided. The entity amortizes the asset over seven years in accordance with paragraph 340-40-35-1 because the asset relates to the services transferred to the customer during the contract term of five years and the entity anticipates that the contract will be renewed for two subsequent one-year periods.

>>>> Costs to Fulfill a Contract

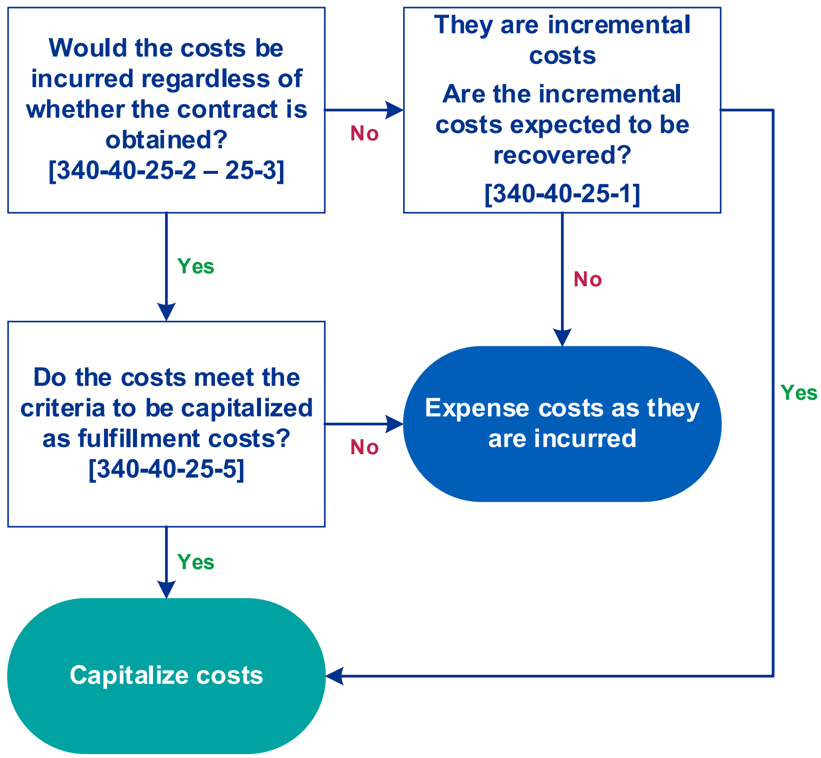
55-7 The initial costs incurred to set up the technology platform are as follows:

Design services	$ 40,000
Hardware	120,000
Software	90,000
Migration and testing of data center	100,000
Total costs	$350,000

55-8 The initial setup costs relate primarily to activities to fulfill the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

a. Hardware costs—accounted for in accordance with Topic 360 on property, plant, and equipment
b. Software costs—accounted for in accordance with Subtopic 350-40 on internal-use software
c. Costs of the design, migration, and testing of the data center—assessed in accordance with paragraph 340-40-25-5 to determine whether an asset can be recognized for the costs to fulfill the contract. Any resulting asset would be amortized on a systematic basis over the seven-year period (that is, the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data center.

55-9 In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity (see paragraph 340-40-25-5(b)). Therefore, the costs do not meet the criteria in paragraph 340-40-25-5 and cannot be recognized as an asset using this Topic. In accordance with paragraph 340-40-25-8, the entity recognizes the payroll expense for these two employees when incurred.



Incremental costs to obtain a contract are capitalized

An entity capitalizes incremental costs to obtain a contract with a customer – e.g. sales commissions (and incremental fringe benefits such as additional payroll taxes or 401k matching contributions incurred as a direct result of paying the sales commission) – if it expects to recover those costs.

However, as a practical expedient that applies only to *costs to obtain a contract* (i.e. the practical expedient does *not* apply to contract fulfillment costs), an entity is not required to capitalize the incremental costs of obtaining a contract if the amortization period of the contract cost asset would be one year or less. For example, sales commissions paid on a contract to sell a software license to a customer bundled with one year of post-contract customer support (PCS) or a one-year software-as-a-service (SaaS) arrangement, and for which renewals are either (a) not specifically anticipated (see Question H250) or (b) a 'commensurate' commission will be paid for any contract renewals (see Question H260) are not required to be capitalized.

Whether to use the practical expedient is an accounting policy choice and can be made when the amortization period associated with the asset that would otherwise have been recognized is one year or less. See discussion of the amortization period beginning with Question H240, which may be longer than the term of the contract if renewals of the contract are specifically anticipated and a 'commensurate' commission (i.e. commensurate to that paid for the initial term) is not paid on the contract renewal. Consistent with other accounting policy choices for which the relevant Topic does not specify at what level an accounting policy choice is applied, the practical expedient related to contract costs is applied on an entity-wide basis to all of its contracts that are eligible for the expedient. That is, if an entity elects to apply the practical expedient, then it applies the practical expedient across all of its business units or segments and to all contracts that qualify for the expedient (regardless of whether the contract that qualifies is a new contract with a customer or a renewal contract).

Only incremental costs are capitalized

Costs that are incurred regardless of whether the contract is obtained – e.g. costs incurred in *pursuing* a contract – are expensed as incurred (unless other accounting is prescribed by another Topic or the costs qualify for capitalization as fulfillment costs). An example of such costs are costs to prepare a bid or draft a contract, which would be incurred even if the entity does not obtain the contract (i.e. the entity would owe its attorney legal fees for drafting the contract even if the customer does not ultimately agree to the contract). Salaries and other benefits that would be paid to employees (including sales personnel) regardless of whether a contract was obtained are not 'incremental to obtaining a contract with a customer'. Fringe benefits that are incurred only as a result of incurring the commission cost (e.g. payroll taxes or pension costs the entity is required to additionally pay as a result of the commission earned by the employee) *are* incremental costs.

Recovery of capitalized costs

Incremental costs to obtain a contract, if recoverable, are recovered through direct or explicit reimbursement by the customer under the contract (i.e. direct recovery) or through the net cash flows expected from the margin built into the contract and any specifically anticipated future contracts with the customer (i.e. indirect recovery).

Recognition of contract cost liabilities

The new revenue and contract cost guidance does not amend the US GAAP guidance applicable to the recognition of liabilities, including liabilities arising from a requirement to pay commissions to employees or third parties. Therefore, entities should recognize liabilities in accordance with other applicable US GAAP in the same manner that they did before the effective date of Subtopic 340-40. If the item being accrued is not addressed by another Topic, Subtopic 340-40 applies in determining whether the debit resulting from the recognition of that liability results in the immediate recognition of expense or a contract cost asset.

In some cases, an additional commission may be payable, or the original commission amount adjusted, at a future date. Examples include (not exhaustive):

- commissions paid for renewal of the contract;
- commissions earned on contract modifications;
- commissions contingent on future events (including continued employment by the commission recipient);
- commissions subject to clawback; and
- tiered commissions subject to a threshold.

In these cases, an entity considers the enforceable rights and obligations created by the arrangement to determine when the liability is accrued and whether to capitalize a commission, and in what amount. For example:

— if an entity pays a commission of $100 upon commencement of a SaaS contract with a non-cancellable one-year term and agrees to pay an additional commission of $100 if the customer renews the contract at the end of the year, then the entity generally capitalizes only the initial commission of $100 on contract commencement. The entity evaluates the second commission of $100 for capitalization only when the customer renews the SaaS contract and, thus, it incurs the liability for the second commission. This is because the contract creates enforceable rights and obligations for both parties only for the initial contract period of one year; the entity does not accrue the second commission payment until it has a present obligation to pay that commission; and

— if an entity pays a commission of $100 on commencement of a contract with a non-cancellable two-year term and agrees to pay an additional commission of $100 on the first anniversary of the contract (without any further performance requirements on the part of the commission recipient), then the entity capitalizes $200 on contract commencement. This is because the contract creates enforceable rights and obligations for both parties for the contract period of two years. The entity accrues the first *and* the second payment because it has a present obligation and payment of the second installment depends only on the passage of time – i.e. the commission is not contingent on the sales person remaining employed; it was earned for obtaining the contract. An entity's practice of not paying a promised commission installment (e.g. a payment due to a salesperson at the beginning of the second year of a contract) if the employee leaves the company before the payment date does not alter this analysis unless the entity's practice in this regard renders such payments unenforceable legally. If a commission will be paid out over an extended period of time, the liability recognized by the entity would generally need to be discounted to its present value pursuant to Subtopic 835-30, *Interest – Imputation of Interest*.

In more complex scenarios, an entity focuses on whether its obligation to pay a commission meets the definition of a liability. In general, if an entity recognizes a liability to pay a commission that qualifies for recognition as an incremental cost of obtaining a contract, then the entity recognizes an asset at the same time. This will be particularly important when considering commission structures that include thresholds – e.g. a commission amount that is payable only if cumulative sales within a given period exceed a specified amount, or the commission rate varies with cumulative sales.

The question over whether to use the practical expedient will be a key implementation decision for some entities.

The assessment of whether the practical expedient applies is made at the contract level. Generally, if a commission paid for a contract relates to multiple goods or services and one or more of those goods or services will be satisfied beyond one year from when the cost is incurred, then the practical expedient will not apply. For example, the practical expedient would generally not apply to a commission paid for obtaining a contract that includes a software license and bundled post-contract customer support (PCS) for an initial two-year period.

Interim reporting considerations

Entities reporting financial information on an interim basis in accordance with Topic 270, *Interim Reporting*, frequently make estimates in assigning costs and expenses to interim periods in accordance with paragraph 270-10-45-4(b) so that interim period results more closely reflect anticipated annual results. For example, entities will frequently estimate certain employee bonuses, and accrue a proportion thereof during interim periods, even though the entity will not owe the bonus to the employee if he/she terminates employment or specified metrics are not met for the year. Such amounts, if related to obtaining a customer contract, would result in recognizing a contract cost asset (see Example H100.1).

Question H40

Do entities have an accounting policy election relative to capitalizing incremental costs of obtaining a contract?

Interpretive response: No. An entity does not have an accounting policy election relative to capitalizing incremental costs of obtaining a contract. The Boards considered whether to allow a policy election under which an entity would be able to choose to capitalize or expense contract costs with disclosure of the accounting policy election. However, the Boards concluded that policy elections would reduce comparability. Consequently, the Boards decided not to allow entities a policy election with respect to incremental costs of obtaining a contract. Instead, the Boards included a practical expedient for costs that, if capitalized, would have a short amortization period (i.e. one year or less).

In addition, while not explicitly stated in Subtopic 340-40, we understand that the amortization period to be considered in determining the availability of the practical expedient begins at the date the costs are incurred. The amortization period in this respect does not refer to solely the period of time over which the goods or services will be provided. For example, if an entity incurs $10,000 in contract acquisition costs as a result of executing a contract on December 1, 20X0, and expects to satisfy the single performance obligation in the contract over an 11-month period beginning April 1, 20X1, those costs would not be eligible to be expensed when incurred on December 1, 20X0 using the practical expedient. Therefore, if the entity in this example is a calendar-year public reporting entity, the full, unamortized amount of those contract acquisition costs would be reflected in the entity's December 31, 20X0 and March 31, 20X1 balance sheets.

Comparison to legacy US GAAP

Under legacy SEC guidance, an entity can elect to capitalize direct and incremental contract acquisition costs – e.g. sales commissions – in certain circumstances. Under Subtopic 340-40, an entity capitalizes costs that are incremental to obtaining a contract if it expects to recover them – unless it elects the practical expedient for costs with amortization periods of one year or less. This may affect those entities that currently elect to expense contract acquisition costs, because they will now be required to capitalize them if the anticipated amortization period for those costs is greater than one year.

Currently, some entities capitalize a portion of an employee's compensation relating to origination activities by analogy to legacy US GAAP on loan origination fees. This is not permitted under the Subtopic 340-40, because these costs are not incremental to a specific contract – i.e. an employee's salary and benefits are paid regardless of whether they successfully consummate a sale.

Question H50

What costs to obtain a contract are 'incremental', and therefore, capitalized if they are expected to be recovered?

Interpretive response: Costs are incremental to obtaining a contract if, and only if, it is the act of both parties approving the contract that triggers the liability for that cost to the entity. For example, costs incurred in trying to obtain a contract (e.g. sales efforts) or in negotiating a contract (e.g. non-contingent legal fees incurred to draft a contract) that are incurred by the entity regardless of whether the entity and the customer both approve the contract are not 'incremental' and, therefore, are expensed as incurred unless another Topic prescribes a different treatment.

Example 1 in Subtopic 340-40 (included in the overview of this section) illustrates this. Only the $10,000 in sales commissions are capitalized because the other costs – i.e. the travel costs and legal fees related to due diligence – are incurred regardless of whether the parties ultimately approve the contract. Put another way, if, at the last second, the customer decides not to approve the contract, the legal fees and the travel costs would still be incurred, and therefore they are not 'incremental' to *obtaining* the contract. Only the sales commission costs would be avoided by the customer ultimately deciding not to approve the contract.

The above position was affirmed by TRG members at the November 2016 TRG meeting (see TRG Agenda Paper No. 60).

Question H60

If a commission will be paid only as the software entity or SaaS provider invoices the customer, but there are no performance requirements for the commission recipient after the entity obtains the contract with the customer, is the entire commission an incremental cost of obtaining a contract at contract inception?

Interpretive response: Yes. The timing of payment of a commission does not affect whether it is a cost incremental to obtaining a customer contract. Invoicing the customer in accordance with the contract (e.g. at the beginning of each year of the contract) is not a performance requirement. The entity would accrue the entire commission at contract inception and recognize a corresponding contract cost asset, unless the practical expedient applies because the entire commission that would be capitalized at contract inception would be amortized over a period of 12 months or less. If the commission will be paid out over an extended period of time, the liability recognized by the entity would generally need to be discounted to its present value.

Question H70

Are commissions that are payable based on obtaining a contract but also require additional, future performance or service by the commission recipient 'incremental costs of obtaining a contract'?

Interpretive response: It depends. As outlined in Question H50, the premise of the contract acquisition costs guidance in Subtopic 340-40 is that if a liability is incurred *because* a contract with a customer was obtained, and that cost would not have been incurred if the contract was not obtained (e.g. the customer decided at the last minute not to approve the contract), it is an incremental cost of obtaining a contract.

Conversely, if the action of the parties approving the contract does *not* trigger the liability, rather it is another action or consequence that triggers the obligation, the cost in question is not an incremental cost of obtaining the customer contract. Other Topics will govern whether an asset, which would not be a contract cost asset (unless it is a fulfillment cost), is recognized. This applies regardless of the form of the commission (e.g. cash or equity).

Consequently, if no liability (or obligation) is incurred (including one to issue equity securities) as a result of contract approval because future service is required by the commission recipient to earn the payment, no *contract acquisition cost* asset would be recognized.

We are aware of some SaaS arrangements in which commissions are due and payable to the salesperson partially at contract inception (e.g. 50% or 60% of the commission is due at contract inception) and the remainder only once the initial year's fee is paid by the customer. If the salesperson discontinues his/her employment between contract inception and when the first-year fee is paid by the customer, that second portion of the commission payment is not owed. In general, if the period of time between contract inception and customer payment is not significant, the service requirement would not be deemed substantive. Therefore, we would not preclude an entity from recognizing the entire commission liability at contract inception. Neither, provided there are no other substantive requirements of the salesperson, would we object to the entity recognizing the entire commission amount as a contract cost asset, even if the entity accrues for the second installment of the commission only after the initial year's fee is paid by the customer. In this context, 'significant period of time' is a matter of judgment, but both qualitative (i.e. the purpose for the provision – e.g. is it fundamentally a cash management issue for the entity) and quantitative (i.e. a shorter service period tends to a conclusion that the service period is not significant) factors should be considered.

Example H70.1
Salesperson performance requirement

ABC Corp. enters into a three-year SaaS contract with Customer. In return for obtaining the contract with Customer, ABC agrees to pay its salesperson a commission of $120,000. The $120,000 commission will be paid in three installments of $40,000 each. Each installment is payable to the salesperson at the beginning of each year of the contract (i.e. at contract inception, at the beginning of Year 2 and at the beginning of Year 3) *provided that the salesperson is still employed by ABC at that time*.

Because there is, in effect, a 'double trigger' with respect to the second and third commission payments – that is, the second and third payments include *both* that the contract has been obtained and that the salesperson fulfill a substantive performance requirement (i.e. remain employed for a significant period of time between contract inception and the commission payment date) – ABC does not accrue for the second and third payments of $40,000 each upon obtaining the customer contract. Consequently, those amounts, when accrued, are not incremental costs of obtaining a contract. Only the initial payment of $40,000 is an incremental cost of obtaining the contract because only that payment is accrued as a result of the contract having been obtained (i.e. approved).

If no renewals are specifically anticipated (see Question H250), the $40,000 will be amortized over the three-year contract term, which is consistent with the transfer of the SaaS to which the incremental cost of obtaining the contract relates.

Questions H240 – H310 discuss amortization of contract cost assets in further detail.

Question H80

Is a payment that depends only partially on obtaining a contract with a customer an 'incremental cost of obtaining a contract'?

Interpretive response: Any fixed amount owed to an employee that is not owed directly as a result of entering into a contract with a customer, such as a fixed salary to a sales manager, even if that fixed amount was established based on an assumption of sales activity with customers, would not qualify for capitalization under Subtopic 340-40, nor would a payment (however characterized – i.e. 'bonus', 'incentive payment' or otherwise) paid based on operating metrics (e.g. net or operating income, EBITDA or gross margin), even if those metrics are significantly affected by sales activities. If a payment is *not* due solely as a result of obtaining one or more customer contracts, such is the case for a potential payment linked to operating metrics other than things like new customer sales or bookings, it is not an 'incremental cost of obtaining a contract'.

Commission and bonus plans are often widely varied and complex. Therefore, such plans will need to be carefully analyzed in order to determine whether payments thereunder should be capitalized under Subtopic 340-40.

Question H90

Are commissions subject to customer performance after the contract is obtained capitalizable?

Interpretive response: A commission plan that pays a salesperson in installments over the contract period may stipulate that the salesperson will not be paid further installments if the customer does not fulfill its obligation to pay the entity under the contract. A commission plan may also pay the salesperson his/her commission upfront but be subject to 'clawback' if the customer does not fulfill its obligation to pay under the contract.

The TRG discussed this issue at the January 2015 TRG meeting and generally agreed that customer nonperformance is not a consideration in determining whether costs to obtain a contract that otherwise meet the criteria for capitalization should be capitalized. This is because, for a contract with a customer to even exist within the new revenue/contract costs model (i.e. for the agreement to pass 'Step 1' of the revenue model – see *Chapter B – Step 1: Identify the contract with the customer*), both parties to the contract must be 'committed to perform their respective obligations' (paragraph 606-10-25-1(a)). Consequently, the accounting for incremental costs of obtaining that contract should follow that conclusion. If circumstances subsequently change, such that doubt arises about whether the customer will perform its future obligations, then the entity would both (1) reassess whether there remains a valid contract between the parties and (2) assess the contract cost asset for impairment in accordance with paragraph 340-40-35-3. If a previously paid commission is 'clawed back' or an existing commission liability (e.g. related to a commission that will be paid over time) is written off, the offsetting entry to the cash received or the liability relieved will generally be to the contract cost asset. However, if the cash received or the liability relieved is greater than the unamortized balance of the related contract cost asset (e.g. because the contract cost asset was previously impaired), the difference is recognized as a contra operating expense.

As a reminder, the fact that the payment of the commission will occur over time does not affect whether the full commission is capitalized upon obtaining the contract (see Question H60); this point was also affirmed by the members of the TRG.

Question H100

Does the reference to 'a contract' in paragraph 340-40-25-1 mean that costs incurred in relation to a pool of contracts should not be capitalized?

Interpretive response: No. Some entities structure their commission plans to pay their salespeople based on a cumulative bookings amount or cumulative contract value for contracts a salesperson obtains during a given period. If the commission is payable based solely on obtaining the customer contracts – that is, the amount payable does not also relate to other substantive actions of the salesperson (e.g. his/her performance against personal development goals or reducing other costs of obtaining customers or contracts) – the costs should be capitalized if they are recoverable.

Other entities structure their commission plans based on an entity- or business unit-wide cumulative booking or contract value target. For example, as illustrated in Example H100.1, a commission 'pool' may be established by an entity based entirely on customer contracts obtained at an aggregate level. Individual salesperson commissions may or may not directly correlate to their contributions to the aggregate target – e.g. Salesperson 1's commission may equal 5% of the value of customer contracts he/she obtained, but Salesperson 2's commission may equal 8% of the value of the customer contracts he/she obtained. We do not believe how an entity allocates its commissions to its salesforce affects whether the commissions are incremental costs of obtaining contracts. Regardless of how an entity chooses to allocate such amounts, if the costs are incurred solely because customer contracts were obtained, they should be capitalized under Subtopic 340-40.

In each of these situations, entities will need to develop a consistent, systematic and rational approach for amortizing such costs (i.e. determining what the goods or services are to which the capitalized amounts relate) (see Question H10).

Example H100.1

Incremental costs of obtaining a pool of contracts

ABC Corp. has a commission plan whereby all of its salespeople are paid an annual amount based on whether the sales department achieved certain bookings targets. Each salesperson is assigned a commission amount that varies based on the achievements of the sales department as a whole in terms of obtaining new and renewal customer contracts. For example, Jane Salesperson will earn $10,000 if ABC obtains $10 million in new bookings, $17,000 if ABC obtains $15 million in new bookings, or $25,000 if ABC obtains $20 million in new bookings. In contrast, Joe Salesperson will earn $8,000, $13,000 or $19,000, respectively, depending on which, if any, cumulative bookings target is met. The amount Jane or Joe will earn based on the entity-wide bookings target does not necessarily correlate with their contributions to meeting the bookings target.

ABC follows the appropriate liabilities guidance in determining whether and when to accrue amounts related to its commission plan. As it accrues the annual commission payout, ABC concludes that the respective costs are incremental costs of obtaining customer contracts. This is because the sole reason ABC is accruing the respective commission liability is obtaining, or the expectation of obtaining, customer contracts. The fact that the commission amount is determined for a pool of customer contracts, rather than on an individual contract basis, does not change that the commission amounts, if any, that will be paid to ABC's salespeople are incremental to obtaining customer contracts and, therefore, within the scope of Subtopic 340-40.

Question H110

Is a commission paid only after achieving a cumulative target an incremental cost of obtaining a contract, and when would it be recognized as an asset?

Interpretive response: The commission is recognized as a cost when a liability is incurred and capitalized at that time if recoverable.

The TRG generally agreed that Subtopic 340-40 does not change when an entity should accrue a commission-related liability. Subtopic 340-40 provides guidance only as to whether the cost should be capitalized or expensed as incurred (unless addressed by other topics).

Most TRG members agreed that if the amount accrued is incremental to obtaining a customer contract and is expected to be recovered, then it should result in a contract acquisition asset. Whether an accrual relates to a cumulative contract acquisition target (such as X number of contracts, $XX in collective customer booking or total contract value) or an individual contract does not affect whether the cost is capitalized under Subtopic 340-40. [TRG Agenda Paper No. 23, TRG Agenda Paper No. 57]

We understand there may be diversity in how entities accrue the cost of commissions over interim periods in similar plans. For example, some entities accrue commissions over interim periods based on their expectation of the total commissions in an annual plan. Other entities may determine that a liability does not exist until each specified threshold is triggered. The timing of liability recognition could determine whether commissions achieved on meeting certain thresholds are allocated to multiple contracts or the contract that triggers the threshold being met. [TRG Agenda Paper No. 23]

Example H110.1

Commission plan with tiered thresholds – cumulative effect

ABC Corp. has a commission plan whereby once a cumulative threshold based on a number of contracts is reached, a commission is paid as a percentage of the cumulative value of that contract and the preceding contracts, taking into account any commission already paid.

Number of contracts	Commission
1–10 contracts	1% of value of contracts
11–20 contracts	4% of value of contracts 1-20
21+ contracts	7% of value of contracts 1-20+

As contracts 1–10 are obtained, ABC owes the salesperson only 1% of the contract value, which would be the *minimum* incremental cost of obtaining each of those contracts. However, the applicable liabilities guidance may result in ABC accruing cost in addition to the 1% because of an expectation of paying additional commissions related to those contracts when other expected contracts are obtained. ABC capitalizes those additional amounts as incremental costs of obtaining customer contracts, if the one-year practical expedient does not apply or has not been elected.

In this example, ABC initially accrues 1% based on the applicable liabilities guidance when it enters into Contracts 1–4. However, by the time ABC enters into Contract 5, it expects that it will enter into at least 11 contracts. At that point, ABC adjusts its expectations and on entering into Contract 5, ABC capitalizes a 4% commission related to Contract 5 and an additional 3% commission related to Contracts 1–4 because 1% was already capitalized.

Note: We understand there may be diversity in how entities accrue the cost of commissions over interim periods in similar plans, which is not addressed by the guidance in Subtopic 340-40.

Example H110.2

Commission plan with tiered thresholds – prospective effect

ABC Corp. has a commission plan whereby once a cumulative threshold number of contracts is reached, a higher commission rate is paid on each subsequent contract for the remainder of the year.

Number of contracts	Commission
1–10 contracts	1% of value of contracts 1-10
11–20 contracts	4% of value of contracts 11-20
21+ contracts	7% of value of contracts 21+

ABC owes only 1% of the contract value when the salesperson obtains each of Contracts 1–10. However, ABC has a policy under Topic 270 for interim reporting purposes of accruing commissions based on its expectation of the annual commissions. [270-10-45-4(b)]

ABC estimates its full-year expectation of the salesperson obtaining 30 contracts and accrues a 4% commission as each contract is obtained. The amounts accrued in interim periods will be trued up to the annual result.

ABC capitalizes each commission amount recognized as the liability is accrued as a contract acquisition asset – assuming the one-year practical expedient does not apply or has not been elected.

Note: We understand there may be diversity in how entities accrue the cost of commissions over interim periods in similar plans, which is not addressed by the guidance in Subtopic 340-40.

Question H120

If an entity pays commissions to personnel other than the salesperson (e.g. a sales manager or sales support staff), are those commissions capitalized (if recoverable)?

Interpretive response: If a sales commission is *directly attributable to, and incremental from,* obtaining a contract (and is expected to be recovered), Subtopic 340-40 requires those amounts to be capitalized. Therefore, if a regional sales manager (and/or any higher-level executive – e.g. a senior or executive vice president) or a member of the sales support team earns a commission that is directly attributable to obtaining one or more customer contracts, and the practical expedient does not apply (or has not been elected), the entity would be required to recognize a contract cost asset for that commission, just as it would any commission paid to the 'direct' sales representative that negotiated the contract. For example, if the direct sales representative earns a commission of 5% of the contract value on a customer contract (or bundle of contracts – see Question H100), and his/her supervisor, the senior vice president of sales and/or a sales assistant each also get a 1% commission on that contract, the entity would recognize a contract cost asset for each of those commissions (i.e. 7% of the contract value).

Some have questioned whether this conclusion would also extend to a commission paid to non-sales staff. For example, continuing the example from the preceding paragraph, assume a person outside of the sales group or sales hierarchy, with no direct or indirect (i.e. sales team support) role in selling to customers, also earns a commission of 1% of the contract value on the customer contract. While we do not believe this is a common occurrence, we do not think the employee's role within the organization (i.e. sales or non-sales role) or 'distance' from the customer negotiation affects whether the commission meets the definition of being an incremental cost to obtain a contract with a customer. Therefore, we believe the 1% commission paid to the non-sales employee is required to be capitalized if it is incremental to obtaining the customer contract and is expected to be recovered.

Question H130

Should an entity capitalize commissions earned on contract modifications that are not treated as separate contracts?

Interpretive response: Yes. The TRG discussed this at its January 2015 meeting and concurred with the FASB and IASB staffs that, regardless of how the contract modification is accounted for, incremental costs of obtaining the modification should be accounted for in the same manner as incremental costs of obtaining a customer contract.

Example H130.1

Commission paid upon contract modification

ABC Corp. enters into a contract with Customer to transfer a software license to Product X and to customize that software for Customer's needs. ABC pays its salesperson a commission based on the contract price. That commission is incremental from obtaining the contract with Customer and is expected to be recovered.

Before the completion of the software customization, ABC and Customer modify the contract through a change order. Under the change order ABC will develop an additional customized feature for Customer for an additional fee. As a result of obtaining the change order, the salesperson will obtain an additional commission consistent with what the salesperson would have received had the contract value reflected this additional feature at inception.

Even though the contract modification is not accounted for as a separate contract, the increase in the contract price results in a cost – i.e. the commission paid to Employee A – that is incremental to obtaining the modified contract that is capitalized consistent with the initially paid commission.

Question H140

Should an entity capitalize commissions paid to obtain contract renewals?

Interpretive response: An entity's commission plan may provide its employees with a commission for each new (i.e. initial) contract obtained with a customer, as well as for each renewal contract (i.e. the renewal of existing contracts). For example, a commission may be paid to a salesperson who obtains an initial contract to provide SaaS to a customer, but also to a salesperson that obtains a contract from an existing customer renewing the SaaS.

A renewal contract is no less of a contract than one for a contract with a new customer under Topic 606 and Subtopic 340-40. Therefore, if a commission is paid to obtain a renewal contract, and that commission is incremental to obtaining that contract and is recoverable, the cost is capitalized just as any cost is capitalized to obtain a contract with a new customer unless the practical expedient applies and has been elected by the entity.

Question H150

Can the practical expedient apply to renewals of a contract, but not the initial contract?

Interpretive response: Yes. An entity may find that its renewal contracts qualify for the practical expedient, but not its initial contracts.

The commission on an initial contract, even one with a term of one year or less, may not qualify for the practical expedient if (1) renewals are specifically anticipated (see Question H250) and (2) commissions paid on renewals are not 'commensurate' with the initial contract commissions (see Question H260). However, if the renewal period is one year or less and renewal commissions are commensurate with each other (even if not commensurate with initial contract commissions), the renewal commissions could qualify for the practical expedient. In that case, if the entity has elected the practical expedient, the entity will expense renewal commissions as incurred.

Question H160

Can an entity apply the costs to obtain a contract practical expedient if only one or some (but not all) of the goods or services to which the contract acquisition costs relate will be satisfied in one year or less?

Interpretive response: The assessment of whether the practical expedient applies is made at the contract level. Generally, if a commission paid for a contract relates to multiple goods or services and one or more of those goods or services will be satisfied beyond one year from when the cost is incurred, which may include goods or services that will be provided under a specifically anticipated future contract, then the practical expedient will not apply. For example, the practical expedient would not apply to a commission paid for obtaining a contract that includes a software license and bundled post-contract customer support (PCS) for an initial two-year period.

In contrast, the practical expedient may be applicable to a commission paid on a contract with goods or services that will be transferred to the customer over a period greater than one year if the contract acquisition costs are determined to relate only to those goods or services that will be transferred to the customer in one year or less (see Question H300).

Question H170

Can the practical expedient for expensing costs to obtain a contract as incurred be applied to commissions for which the amortization period, if capitalized, would be only slightly greater than one year?

Interpretive response: No. Entities may have administrative or other reasons (e.g. standard billing practice) that result in a contract term slightly greater than 12 months (e.g. 12 months and 15 days). This may be the case even if the contract period is intended to approximate one year. The practical expedient is a bright-line exception to the contract cost capitalization requirement in Subtopic 340-40. As with other exceptions in the accounting literature, they are applied narrowly as written by the FASB. Consequently, costs for which the amortization period would extend beyond one year, no matter by how much, are not eligible for the practical expedient.

Example H170.1

Practical expedient when amortization period is slightly longer than one year

SaaS Company C enters into arrangements with customers where if the contract term and services begin at a date that is other than the 1st of the month, the contract term will be set such that the end date is at the end of the month after one year from the effective date. Therefore, unless the effective date is on the 1st of the month, the contract term will be greater than one year (i.e. services will be provided over a period longer than one year).

SaaS Company C enters into a contract with Customer A on December 10, 20X1. Based on its administrative practices, even though the effective date of the contract is December 10, 20X1, the contract term will end December 31, 20X2. The Company has a commission policy for which its salespeople are paid 5% of sales at the time a contract is entered into and this cost is amortized over the one year and three-week service period of the initial contract.

In this scenario, SaaS Company C would not be able to apply the practical expedient to expense commissions as incurred as a result of obtaining the contract because the amortization period is longer than one year.

Question H180

Are anticipated contracts (e.g. contract renewals) included when determining whether the practical expedient applies?

Interpretive response: If specifically anticipated contracts (see Question H240) would be included in the amortization period of the contract cost asset if it were to be capitalized, those renewals factor into whether the practical expedient is available because the practical expedient applies to the period over which the costs would be amortized, not over the contract period.

For example, if a SaaS provider incurs incremental costs to obtain a one-year contract with a customer for which renewals of that one-year contract are anticipated *and* the SaaS provider will not pay commensurate commissions for those renewals (see Question H260), the amortization period for the initial SaaS contract commission would be greater than one year and the practical expedient would not be available.

Question H190

What is the accounting if an entity applies the practical expedient not to capitalize costs to obtain a contract but subsequently determines that the amortization period is greater than one year?

Interpretive response: The entity should consider the guidance in Topic 250 on accounting changes and estimates. If changes in circumstances lead the entity to change its earlier estimate as to the timing of the satisfaction of the performance obligation, no accounting would be required for costs previously expensed as changes in accounting estimates are accounted for prospectively.

However, if the earlier determination that the amortization period would be less than a year was attributable to a misunderstanding of the facts and circumstances that existed at contract inception and were reasonably available to management at that time, leading to the entity inappropriately expensing the contract acquisition costs, the entity would have an accounting error and would need to assess the materiality of the error and any related correction to current and prior periods to determine the appropriate process for correcting the error.

Question H200

What should an entity consider with respect to fees paid to a third party used to generate sales and provide implementation services when applying the guidance in Subtopic 340-40?

Interpretive response: An entity may use a third party to both generate sales and to provide implementation (or other professional) services to its customers.

If that is the case, entities should allocate the fee on a systematic and rational basis based on the nature of the activities performed by the third party. For example:

— any portion of the fees paid to the third party that are incremental to obtaining the customer contract *alone* – i.e. attributable only to reselling the contract – should be accounted for in the same way as any other incremental costs of obtaining a contract with a customer;

— any portion of the fees that relate to the third party performing set-up activities should be accounted for consistent with any internal costs the entity would incur to perform those set-up activities – see Question H220; and

— any portion of the fees that relate to the third party providing services to the customer on the entity's behalf (i.e. for which the entity is the principal for those services) should be accounted for in the same manner as any other fulfillment costs the entity would otherwise incur itself to fulfill its promise to provide those services to the customer – see Question H230.

Determining whether any portion of a third-party fee in an arrangement where the third party will also be providing services on behalf of the entity is solely incremental to reselling the customer contract will require judgment. It is important to recall, just as for commissions paid to employees (see Questions H70 and H80), costs that are incremental to obtaining a contract with a customer include only those costs that are incurred solely as a result of obtaining the contract. If payment of the entire fee is contingent on successfully performing the services (or set-up activities), then no part is incremental to obtaining the customer contract.

Costs of fulfilling a contract

Overview

Excerpt from ASC 340-40

>> Costs Incurred in Fulfilling a Contract with a Customer

15-3 The guidance in this Subtopic applies to the costs incurred in fulfilling a **contract** with a **customer** within the scope of Topic 606 on **revenue** from contracts with customers, unless the costs are within the scope of another Topic or Subtopic, including, but not limited to, any of the following:

a. Topic 330 on inventory
b. Paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements
c. Subtopic 350-40 on internal-use software
d. Topic 360 on property, plant, and equipment
e. Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed.

>> Costs to Fulfill a Contract

25-5 An entity shall recognize an asset from 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.
c. The costs are expected to be recovered.

25-6 For costs incurred in fulfilling a contract with a **customer** that are within the scope of another Topic (for example, Topic 330 on inventory; paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements; Subtopic 350-40 on internal-use software; Topic 360 on property, plant, and equipment; or Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed), an entity shall account for those costs in accordance with those other Topics or Subtopics.

25-7 Costs that relate directly to a contract (or a specific anticipated contract) include any of the following:

a. Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer)
b. Direct materials (for example, supplies used in providing the promised services to a 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)
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).

25-8 An entity shall recognize the following costs as expenses when incurred:

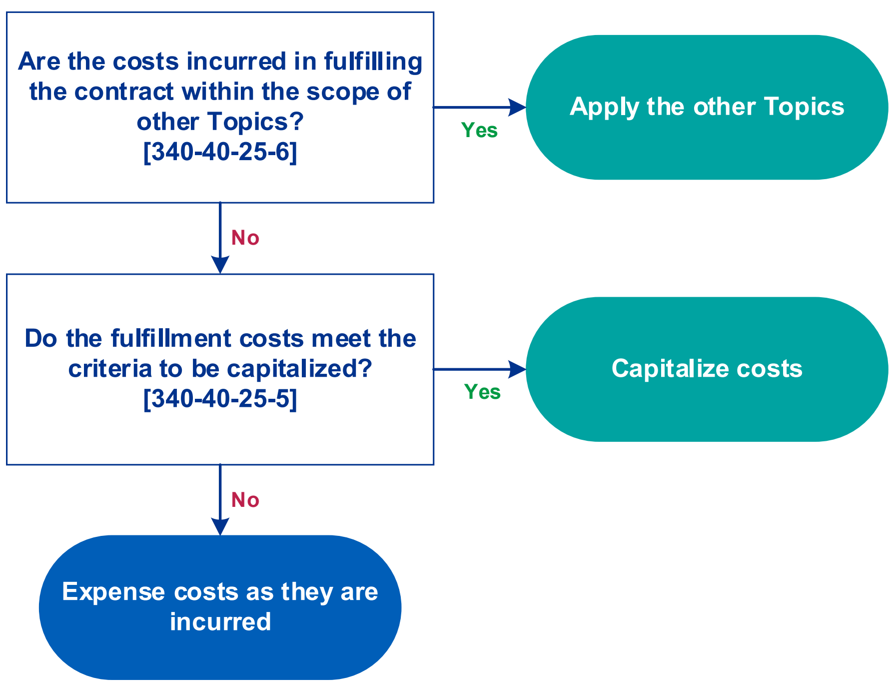
a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 340-40-25-7)
b. Costs of wasted materials, labor, or other resources to fulfill the contract that were 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)
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).

Entities often incur costs to fulfill a contract once it is obtained but before transferring goods or services to the customers. For example, a SaaS provider may incur costs associated with set-up activities subsequent to securing the contract that do not provide a service to the customer. There may be costs incurred in anticipation of winning the contract. In those situations, the standard requires that the costs be associated with a *specific* anticipated contract – i.e. the revenue contract with the customer may not be finalized at the time the costs are incurred.

Entities are required to first determine whether the appropriate accounting for these costs are addressed by other applicable literature. If the costs incurred to fulfill a contract are in the scope of other guidance, then the entity accounts for them in accordance with that other guidance.

If the costs incurred in fulfilling a contract with a customer are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant and equipment – then an entity recognizes an asset only if the fulfillment costs meet the following criteria:

- they relate directly to an existing contract or specific anticipated contract;
- they generate or enhance resources of the entity that will be used to satisfy performance obligations in the future; and
- they are expected to be recovered.



The following are examples of costs that may or may not be capitalized when the specified criteria are met.

Direct costs that are eligible for capitalization if other criteria are met ✓	Costs required to be expensed when they are incurred ✗
Direct labor – e.g. employee wages	**General and administrative costs** – unless explicitly chargeable under the contract
Direct materials – e.g. supplies	**Costs that relate to satisfied performance obligations**
Allocation of costs that relate directly to the contract – e.g. depreciation and amortization	**Costs of wasted materials, labor or other contract costs**
Costs that are explicitly chargeable to the customer under the contract	**Costs that do not clearly relate to unsatisfied performance obligations**

Questions & answers

Question H210

Can entities capitalize fulfillment costs incurred before approval of the related contract (i.e. pre-contract costs)?

Interpretive response: Fulfillment costs (not governed by other Topics, such as start-up costs within the scope of Subtopic 720-15 or research and development costs within the scope of Subtopic 730-10) can be capitalized under Subtopic 340-40 if they relate to specifically identifiable anticipated contracts, which includes unpriced change orders expected to be approved, assuming they also meet the other criteria in paragraph 340-40-25-5 for capitalization. Those other criteria are that the costs generate or enhance resources of the entity that will be used in satisfying future performance obligations (the performance obligations that will be created by the contract if it is obtained) and are expected to be recovered.

Comparison to legacy US GAAP

Under legacy US GAAP (*for those contracts within the scope of Subtopic 605-35*), pre-contract costs directly associated with a specifically anticipated contract were capitalizable if their recoverability from that contract was probable and they were not start-up costs within the scope of Subtopic 720-15. Capitalization of pre-contract costs was limited to contracts within the scope of Subtopic 605-35 (i.e. long-term construction- and production-type contracts).

Under Subtopic 340-40, pre-contract costs that meet the criteria for capitalization in paragraph 340-40-25-5 are required to be capitalized, regardless of the type of contract.

The requirement to potentially capitalize pre-contract costs in situations other than those that were previously within the scope of Subtopic 605-35, such as contracts to significantly modify or customize software, may be new for entities that are required to do so.

Example H210.1

Contract fulfillment costs in a specifically anticipated service contract

PS Co. provides cloud-based services, including access to its software on a SaaS basis. PS previously entered into a master services contract with Customer X, under which it has been named a preferred provider. Under the preferred provider contract, PS expects to enter into a number of individual contracts (e.g. multiple statements of work) with Customer X.

PS will be reimbursed for certain costs incurred in anticipation of, and related to, future cloud-based contracts regardless of whether the contract is ultimately executed. PS incurs labor costs in anticipation of, and which specifically relate to, a contract with Customer X. A portion of those costs are subject to the reimbursement provisions of the preferred provider contract, while the remainder are not. PS has performed similar services in anticipation of similar professional services contracts for Customer X in the past. Customer X has fulfilled its obligations under the preferred provider contract in each case.

In this example, PS capitalizes the labor costs that the preferred provider agreement specifies PS will be reimbursed for regardless of whether there is an executed contract because those costs are explicitly reimbursable. Additionally, for costs that are not explicitly reimbursable under the preferred provider agreement, PS will be required to evaluate whether:

— the costs are directly attributable to a specifically anticipated future contract;
— the costs enhance resources of the entity that will be used in satisfying a future performance obligation (the services under the anticipated contract); and
— the costs are expected to be recovered.

Based on PS's historical experience, and the nature of work and costs incurred for Customer X, PS determines those costs can be capitalized because they meet each of the three criteria outlined above.

PS's accounting for the costs and the reimbursements from Customer X varies depending on whether PS obtains the specific contract to which the incurred costs relate. If the contract is not ultimately obtained, any capitalized costs that will not be reimbursed are expensed once it is clear the contract will not be obtained. Meanwhile, any capitalized costs to which PS is entitled to reimbursement would be converted from a contract cost asset to a receivable. If the contract is obtained, all of the capitalized pre-contract costs are accounted for consistent with any other capitalized fulfillment costs and the reimbursement for those costs becomes part of the transaction price of the obtained contract.

Question H220

Are costs related to fulfilling set-up activities capitalized under Subtopic 340-40?

Interpretive response: SaaS providers often incur costs related to set-up activities – i.e. activities that do not transfer a promised good or service to the customer, as do some on-premise software licensing entities that provide hosting services. Costs incurred to fulfill a promised good or service should be distinguished from costs incurred as part of performing set-up activities. Question C220 addresses distinguishing set-up activities from promised services in software licensing and SaaS arrangements.

Entities will be required to capitalize costs related to set-up activities, because such costs do not relate to satisfying a performance obligation (see paragraph 340-40-25-8(c)), *provided that* those costs directly relate to a customer contract (or specific anticipated customer contract), are expected to be recoverable *and* generate or enhance resources of the entity. Set-up activities frequently, but not always, generate or enhance resources of the entity to permit them to provide services to the customer (e.g. SaaS or hosting services), and generate revenues from those services, in the future.

Costs incurred to fulfill a promised service (e.g. implementation, configuration and/or customization services) are discussed in Question H230.

Comparison to legacy US GAAP

Although there is no specific authoritative guidance under legacy US GAAP, fulfillment costs are generally expensed as they are incurred for arrangements outside the scope of Subtopic 605-35. For certain set-up costs, however, entities may make an accounting policy election under SEC staff guidance to either expense or capitalize these costs.

Entities that currently have an accounting policy to expense set-up costs will be required to capitalize them under Subtopic 340-40 when the requirements for capitalization are met. Entities that already capitalize such costs may not find their accounting for such costs significantly changed in that, under the SEC staff guidance and under Subtopic 340-40, the amounts capitalized and the amortization period for such capitalized costs will likely be similar.

Question H230

Are direct costs incurred in satisfying a present performance obligation eligible for capitalization?

Interpretive response: Unless the costs are addressed by another Topic (e.g. software development costs, which are addressed by Subtopic 350-40 for internal-use software and Subtopic 985-20 for software that is or will be licensed to customers), the answer is generally no. In order for fulfillment costs that are not within the scope of another Topic to be capitalizable, paragraph 340-40-25-5 specifies that the costs must 'generate or enhance resources of the entity that will be used in *satisfying (or in continuing to satisfy) performance obligations in the future*." "Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)" are expensed as incurred (see paragraph 340-40-25-8(c)). This means that contract costs incurred in fulfilling a promised good or service (e.g. costs incurred to fulfill software or SaaS implementation services, even *if* they are not distinct (see *Chapter C – Step 2: Identify the performance obligations in the contract*)) are not capitalizable unless either:

— they are 'pre-contract costs' incurred in anticipation of providing a good or service under a contract with a customer in the future (and they are expected to be recovered); or
— they are costs incurred to permit the entity to fulfill a performance obligation that will be satisfied in the future.

Contract costs incurred in fulfilling a performance obligation satisfied over time are expensed as incurred *even if that results in recognizing fulfillment costs ahead of or subsequent to recognizing the related revenue*. This might occur, for example, if the entity determines that an appropriate measure of progress for the performance obligation is a measure other than cost-to-cost and fulfillment costs are greater in earlier (or later) stages of the project. TRG agenda paper No. 53, and the related discussion of the TRG at the April 2016 TRG meeting, made clear that an appropriate measure of progress applied to a performance obligation satisfied over time should not result in the recognition of work in process (or a similar asset) from an entity's performance under a specific contract.

This would include, in our view, situations in which performance has commenced (i.e. the entity has performed part of a service), but the single measure of progress the entity has concluded is appropriate for the performance obligation does not yet result in revenue being recognized (e.g. see Questions F240 and F270). In those cases, the fulfillment costs to satisfy the performance obligation are expensed as incurred on the basis of paragraph 340-40-25-8(c), even if that occurs in the infrequent circumstance where costs are incurred before any revenue being recognized on the performance obligation based on the measure of progress selected.

The preceding paragraph notwithstanding, some may not view fulfillment costs incurred before any revenue is recognized (based on the single measure of progress selected) as relating to a satisfied or partially satisfied performance obligation – i.e. they do not 'fail' the criterion in paragraph 340-40-25-8(c) – such that the costs might, in limited circumstances, qualify for capitalization under paragraph 340-40-25-5 (i.e. if those criteria are all met, including that those costs generate or enhance resources of the entity).

Reimbursable costs

The discussion in this question applies equally to fulfillment costs that are reimbursable under the terms of the customer contract – e.g. travel-related expenses or costs of supplies incurred by the entity in fulfilling software or SaaS professional services that are reimbursable from the customer. *Chapter D – Step 3: Determine the transaction price*, addresses the accounting for the customer's reimbursement of such expenses.

Example H230.1

Costs incurred in a SaaS arrangement

This is a continuation of Example C220.1.

ABC Corp. enters into a contract to provide Customer with access to its SaaS for three years. As part of the contract, before commencement of the SaaS term, ABC will set up the user interface that Customer will need to access the online application, and will also undertake data conversion and migration activities for Customer to configure and move its relevant, existing data from Customer's current on-premise solution to ABC's hosted environment. ABC will also provide training to relevant Customer personnel on best practices for efficient use of ABC's hosted application.

ABC evaluates each of the activities it agrees to undertake as part of the contract – that is, the set-up of the user interface, data conversion and migration activities, and training of Customer's personnel, and concludes the following as to the nature of those activities (i.e. as a set-up activity or a promised service) and accounting for the related costs:

— ABC's set-up of the user interface is a set-up activity, rather than a promised service to Customer, because it provides no incremental benefit to Customer beyond permitting Customer to access the hosted application. Consequently, assuming the set-up activities are directly identifiable to the contract with Customer and are expected to be recoverable, ABC will capitalize a contract cost asset for those set-up costs.

— The data conversion and migration activities are services that will provide Customer with incremental benefits beyond just access to the hosted application. The data conversion and migration activities would otherwise need to be performed by Customer or another service provider and will permit Customer to more effectively use the hosted application to which it could be provided access without obtaining data conversion or migration services. Similarly, the training of Customer's personnel is also a promised service because the training will permit Customer to effectively use ABC's hosted application. Consistent with the conclusion in Question C280, the data conversion/migration and training services are distinct from the SaaS. Because the data conversion and migration activities and the training of Customer's personnel are promised services, and assuming (*as would typically be the case*) that both of those services are satisfied over time (see

Question F190), the costs of fulfilling those services do not qualify for capitalization under Subtopic 340-40 and, therefore, are expensed as incurred.

Question H235

If an initial contract results in a loss but there is an expectation that subsequent sales will be profitable, can the initial loss be capitalized?

Interpretive response: No. Sometimes an entity may offer a discounted price on a good or service to establish or enhance a customer relationship or to encourage future purchases. These types of arrangements could result in a loss on the initial contract depending on what the discounted price is compared to the cost. It is not appropriate to defer that loss based on an anticipation that subsequent profitable contracts will be entered into with the customer.

In contrast, in some instances entities can capitalize and defer upfront payments to customers (see Question D370).

Amortization and impairment of contract cost assets

Overview

Excerpt from ASC 340-40

> Amortization and Impairment

35-1 An asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 shall be amortized on a systematic 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 described in paragraph 340-40-25-5(a)).

35-2 An entity shall 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. Such a change shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

35-3 An entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 exceeds:

a. The amount of consideration that the entity expects to receive in the future and that the entity has received but has not recognized as revenue, in exchange for the goods or services to which the asset relates ("the

consideration"), less
b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses (see paragraphs 340-40-25-2 and 340-40-25-7).

35-4 For the purposes of applying paragraph 340-40-35-3 to determine the consideration, an entity shall use the principles for determining the **transaction price** (except for the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk. When determining the consideration for the purposes of paragraph 340-40-35-3, an entity also shall consider expected contract renewals and extensions (with the same customer).

35-5 Before an entity recognizes an impairment loss for an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5, the entity shall recognize any impairment loss for assets related to the contract that are recognized in accordance with another Topic other than Topic 340 on other assets and deferred costs, Topic 350 on goodwill and other intangible assets, or Topic 360 on property, plant, and equipment (for example, Topic 330 on inventory and Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed). After applying the impairment test in paragraph 340-40-35-3, an entity shall include the resulting carrying amount of the asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 in the carrying amount of the asset group or reporting unit to which it belongs for the purpose of applying the guidance in Topics 360 and 350.

35-6 An entity shall not recognize a reversal of an impairment loss previously recognized.

Amortization

An entity amortizes the asset recognized for the costs to obtain and/or fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good(s) or service(s) to which the asset relates. The goods or services to which a contract cost asset relates can include the goods or services in an existing contract *and* those to be transferred under a specifically anticipated contract – e.g. goods or services to be provided following the renewal of an existing contract.

If a contract cost asset relates to two or more goods or services that have a different pattern of transfer to the customer (e.g. one transferred at a point in time and another provided over time), entities should either:

— allocate the contract cost asset to those multiple goods or services on a systematic and rational basis; or
— select a single measure that best reflects 'use' of the asset as the goods and services are transferred.

SEC guidance on income statement classification (Regulation S-X, Rule 5-03) requires costs and expenses applicable to sales and revenues to be presented separately from selling, general and administrative expenses. Subtopic 340-40 does not change that guidance. Therefore, the fact that Subtopic 340-40 may require capitalization of certain contract acquisition and contract fulfillment costs does not change the nature of those costs, and their classification in the income statement remains the same as it would have been for similar costs that are not capitalized. Consequently, amortization of costs to obtain a contract will generally be classified as selling, general and administrative expense, while amortization of costs to fulfill a contract will generally be classified as costs of sales (revenue). Software entities will need to determine the appropriate costs of sales (revenue) category in which to classify the fulfillment costs amortization.

Impairment

An entity recognizes an impairment loss to the extent that the carrying amount of the asset exceeds the recoverable amount. The 'recoverable amount' is defined as the:

— expected amount of consideration to be received in the future plus any amounts previously received but not yet recognized as revenue in exchange for the goods or services to which the asset relates; less
— costs that relate directly to providing those goods or services and that have not been recognized as expenses.

When assessing a contract cost asset for impairment:

— the amount of consideration included in the impairment test is based on an estimate of the amounts that the entity expects to receive, which includes amounts the entity expects to receive under specifically anticipated future contracts (e.g. renewals of PCS, hosting services in a software licensing arrangement or SaaS). To estimate this amount, the entity uses the principles for determining the transaction price, with two key differences:
  – it does *not* constrain any estimate of variable consideration – i.e. it includes its estimate of variable consideration (determined in accordance with paragraphs 606-10-32-5 through 35-9), regardless of whether the inclusion of this amount could result in a significant revenue reversal if it is adjusted; and
  – it adjusts the amount to reflect the effects of the customer's credit risk.
— the consideration the entity expects to receive includes both the amount of consideration that it has already received, but has not recognized as revenue, and the amount that it expects to receive in exchange for the goods or services to which the contract cost asset relates.

The specific contract cost asset impairment guidance in Subtopic 340-40 is applied *after* any existing asset-specific impairment guidance (e.g. that in Subtopic 985-20 pertaining to capitalized software development costs), but *before* application of the impairment guidance applicable to long-lived identifiable assets and goodwill.

Sequencing of impairment testing is as follows.

1	Asset-specific impairment guidance (e.g. external-use software under Subtopic 985-20, and uncompleted internal-use software under Subtopic 350-40 – see sections 6.4.30 and 6.2.40, respectively, in KPMG Handbook, Software and website costs)
2	Contract cost assets under Subtopic 340-40
3	Long-lived identifiable assets and goodwill (Topic 350 and Topic 360)

Questions & answers

Question H240

When should capitalized cost assets be amortized over a period that is longer than the specified contract period – i.e. include specifically anticipated renewal periods?

Excerpt from ASC Master Glossary

Useful Life

The period over which an asset is expected to contribute directly or indirectly to future cash flows.

Interpretive response: As stated in the Basis for Conclusions to ASU 2014-09 (BC309), the amortization period for a contract cost asset should include specifically anticipated renewal periods (see Question H250) when, consistent with the concept of amortizing an asset over its 'useful life' under other Topics, the entity concludes that it will continue to benefit from the contract cost asset – i.e. in the form of the net cash flows (margin) it will earn from transferring goods or services to the customer – over a period that is longer than the stated contract period.

If renewals are anticipated, a contract fulfillment cost asset will generally have a useful life that includes those anticipated renewals, while a contract acquisition cost asset will also generally have a useful life that includes those anticipated renewals unless the entity incurs incremental costs (e.g. pays incremental commissions) to obtain the renewals that are 'commensurate' with the incremental costs incurred (i.e. the commissions paid) to obtain the initial contract (see Question H260).

At the November 2016 TRG meeting, the FASB staff explained that the amortization period for a contract cost asset is not necessarily the same as the average customer life for the entity's goods or services to which the contract cost asset relates. However, the staff expressed the view that the average customer life for those goods or services may be a reasonable application of Subtopic 340-40 when the average customer life is not "inconsistent with the amortization guidance in paragraph 340-40-35-1." Based on the staff analysis and the TRG discussion, the average customer life may be inconsistent with the amortization guidance if the entity has a very long average customer life (e.g. 20 years), but the good or service that will be transferred to the customer has an economic life substantially shorter than that (e.g. because the economic life of the software being licensed, or accessed in a SaaS arrangement, is shorter than the average customer life).

Example H240.1
Amortization period for contract cost assets

Company X enters into a one-year contract with Customer Z to provide enterprise cloud management services through a SaaS platform for an amount of $30 per month. Company X pays its salesperson a 5% commission (i.e. $18) and incurs set-up costs of $150 directly related to the contract. Company X does not pay commissions upon renewal and the set-up costs are not incurred by Company X again if the cloud management services are renewed by the customer. Company X's costs of providing the services for the one-year initial service period are $50, which is in-line with its expected costs of providing the services in the future. Company X anticipates, based on relevant customer-specific facts and other relevant circumstances, that Customer Z will renew the contract for an additional three years – i.e. it expects to provide four years of services in total.

Company X concludes that its acquisition costs ($18) and its set-up costs ($150) are directly related to the Customer Z contract and are recoverable by the margin it expects to earn on the contract and the specifically-anticipated renewals. Company X further concludes that the set-up activities enhance its resources necessary to provide the services. Therefore, Company X capitalizes the acquisition costs and the set-up costs as contract cost assets. Because Company X anticipates that Customer Z will enter into three one-year renewals beyond the initial one-year contract term, and will not incur similar costs to obtain or set up those renewals,

Company X expects to benefit from its contract acquisition and contract fulfillment cost assets over a period that includes the initial term plus the specifically anticipated renewal periods (i.e. four years in total). Therefore, Company X concludes that the contract cost assets relate to the four years of service that will be provided under the initial contract and the anticipated renewals and will amortize those assets over the four-year period in a manner consistent with the transfer of those services to Customer Z.

Question H250

When is a renewal of a good or service 'specifically anticipated'?

Interpretive response: Subtopic 340-40 does not specify how an entity should determine whether one or more future contracts (including renewals) are specifically anticipated, so that practice is likely to develop over time. Relevant factors to consider may include the entity's history with that customer (e.g. in other contracts) and customer class, and predictive evidence derived from substantially similar contracts. In addition, an entity should consider available information about the market for its goods or services beyond the initial contract term – e.g. whether it expects the service still to be in demand when renewal would otherwise be anticipated, and expected availability of competitor goods and services (including switching costs and other barriers to switching to another service provider). Judgment will be involved in determining whether renewals of goods (e.g. term licenses) or services are anticipated, but entities should apply consistent estimates and judgments across similar contracts.

Example H250.1

Amortization of costs over specifically anticipated contracts

Continuing Example H240.1, Company X expects Customer Z to renew the initial one-year services contract for three additional years (i.e. Company X anticipates Customer Z will be a customer for those services for four years in total).

The four-year anticipated service period, including renewals, is based on Company X's experience with similar customers in the same market – i.e. Company X considers that customers such as Customer Z generally incur a significant cost and effort to change cloud management service solutions such that most customers renew their contracts multiple times after the initial service period. However, because technology is continuing to evolve in this space, Company X has observed that many customers migrate to a new service offering (which does not include upgrades that one would expect to see implemented over a multi-year period) after four years, whether one provided by Company X (for which Company X would generally incur additional set-up and acquisition costs) or by another cloud service provider.

Question H260

When is a commission paid for the renewal of a good (e.g. a term license) or service 'commensurate with' a commission paid on the initial good or service?

Interpretive response: Software entities, whether providing on-premise software or SaaS, frequently pay commissions to salespeople or third parties for both initial contracts (e.g. an initial one-year SaaS arrangement or three-year term license) and renewal contracts (e.g. renewals of those initial SaaS arrangements or term licenses). It is also common for the commissions paid for the initial contract to be substantially greater in amount than commissions paid for a renewal contract (e.g. the entity may pay a commission of 5% of the total contract value for an initial contract and only 1% of the total contract value for a renewal of the same license or service). Consequently, the question arose as to whether that difference in commission amounts between the initial contract and the renewal contract automatically meant that the renewal commission was not 'commensurate with' the initial commission.

Stakeholders raised questions about the evaluation of whether a renewal commission is commensurate with an initial commission should focus on the commission amount in comparison to the expected contract value or on the comparative 'level of effort' expended by the employee or third party to which the entity pays the commission.

At the November 2016 TRG meeting (TRG Agenda Papers Nos. 57 and 60), the FASB staff stated, and TRG members generally agreed, that the evaluation of whether a renewal commission is 'commensurate with' an initial commission should *not* consider the comparative 'level of effort' expended by the employee or third party to which the entity pays the commission. *Rather*, when making the 'commensurate' evaluation, an entity should consider whether the economic benefits it expects to obtain from payment of the commission (i.e. the margin it expects to earn from providing the good or service) is commensurate with the commission paid. Therefore, in a situation where the expected economic benefits an entity expects to obtain from providing services (e.g. SaaS) during a renewal period are commensurate with the economic benefits the entity expects to obtain from providing those same services during the initial period, the renewal and initial commissions that will be paid must be roughly equal to be considered 'commensurate' with each other. Entities do not, in general, pay substantially different amounts for the same asset (i.e. the same economic benefits). Therefore, a substantively larger initial contract commission represents, both practically and conceptually, a prepayment for the economic benefits that the entity anticipates receiving from the renewal contracts, justifying an amortization period for the initial contract acquisition cost asset that includes the renewal periods.

Consequently, in the common scenario where an entity pays significantly larger commissions for initial contracts than for renewal contracts, those lower renewal commissions are considered to be 'commensurate with' the higher initial contract commissions only if the economic benefits the entity will derive (i.e. the margin it will earn) from the initial contract significantly exceeds those it expects to derive from the renewal contracts.

Example H260.1

Whether a commission paid for a renewal is 'commensurate'

A cloud service provider (CSP) provides SaaS to its customers. The SaaS is generally sold with a one year-term, with multiple options to renew the services annually after each one-year term expires. CSP has a compensation plan that pays its sales staff commissions for obtaining and renewing contracts. Under this plan, a sales person receives a 5% commission on any initial contract that is obtained and a 1% commission on renewal contracts that are obtained. The sales personnel that obtain, and are paid commissions on, the initial contract are different personnel from those that obtain, and are paid commissions on, the renewal contracts because CSP has different sales departments responsible for obtaining new customers and for renewal efforts. In determining commission rates to be paid on obtaining initial and renewal contracts, CSP factors in the effort necessary to secure the initial and renewal contracts by the applicable sales team and the average annual compensation that the sales personnel (both initial and renewal team) should receive, among other factors.

Obtaining an initial contract generally requires a significant amount of effort from the sales staff. The sales effort can vary from prospective customer to customer, but generally requires several hours (spanning over several months). There is generally significantly less effort required in order to secure the renewal, which may only involve making a few phone calls or sending an email to confirm the customer wants to renew. CSP has a low attrition rate – historically greater than 90% of all one-year SaaS contracts are renewed for at least two additional years. The low attrition rate is, in part, a result of the significant level of data input, integration with existing systems and employee training that is necessary in order for CSP's customers to fully use the SaaS.

CSP agrees to provide SaaS for a term of one-year to Customer for $100,000. Customer has the option to renew the SaaS at the end of each year for $100,000 per year. Based on its compensation plan, CSP pays the sales person $5,000 for obtaining the initial contract, and will pay $1,000 to the different sales person that obtains each renewal contract.

CSP determines that the $5,000 paid to the sales person that obtained the initial SaaS contract should be capitalized as it is an incremental cost of obtaining a contract in accordance with paragraph 340-40-25-1. CSP also determines that any renewal commissions paid should also be capitalized when/if incurred as incremental costs of obtaining that (those) contract(s) – i.e. even though the renewal commissions would be eligible for the practical expedient (see Question H150), assume CSP has not elected the practical expedient.

The following are the relevant economics of the arrangement under three different scenarios. Under each scenario, the revenues that will be earned by CSP are the same, as are the commissions paid to CSP's salespeople. The only difference is in CSP's costs to provide the SaaS and, consequently, the gross margin CSP will earn from the initial versus the renewal contracts.

Scenario 1

	Initial contract	Expected renewal 1	Expected renewal 2
Revenue	$100,000	$100,000	$100,000
Cost of services	(30,000)	(30,000)	(30,000)
Gross margin (exclusive of commission costs)	**$ 70,000**	**$ 70,000**	**$ 70,000**
Commission paid	**$ (5,000)**	**$ (1,000)**	**$ (1,000)**

Scenario 2

	Initial contract	Expected renewal 1	Expected renewal 2
Revenue	$100,000	$100,000	$100,000
Cost of services	(10,000)	(50,000)	(50,000)
Gross margin (exclusive of commission costs)	**$ 90,000**	**$ 50,000**	**$ 50,000**
Commission paid	**$ (5,000)**	**$ (1,000)**	**$ (1,000)**

Scenario 3

	Initial contract	Expected renewal 1	Expected renewal 2
Revenue	$100,000	$100,000	$100,000
Cost of services	(42,000)	(30,000)	(30,000)
Gross margin (exclusive of commission costs)	**$ 58,000**	**$ 70,000**	**$ 70,000**
Commission paid	**$ (5,000)**	**$ (1,000)**	**$ (1,000)**

In Scenarios 1 and 3, the renewal commission is not 'commensurate with' the initial commission. This is because the commission paid is five times greater than the renewal commissions that will be paid, but the economic benefits (i.e. the margin) the entity expects to obtain from the renewal contracts are equal (Scenario 1) or greater (Scenario 3) than the economic benefits the entity expects to obtain from the initial contract. Therefore, the substantially greater initial contract commission is a partial prepayment for the economic benefits CSP specifically anticipates receiving from the renewal periods.

In Scenario 2, the economic benefits CSP will derive (i.e. the margin it will earn) from the initial contract significantly exceed those it expects to derive from the renewal contracts. Consequently, the commissions to be paid for each of the three contracts (i.e. initial contract and two renewals) are commensurate with each other. This scenario is presented to illustrate the notion of 'commensurate'; however, we would expect this scenario to be rare in practice.

The amortization of the 5% initial commission that results in each scenario presented above is addressed in Question H270.

Question H270

If the amortization period for a contract acquisition cost asset includes specifically anticipated renewal periods, should the entire asset be amortized over that period or only the amount that is incremental to the commission the entity will pay for the renewal?

Interpretive response: We believe either approach could be acceptable provided it was applied consistently to substantially similar circumstances. To illustrate the effect of this conclusion, we can consider this conclusion in relationship to Example H260.1 in Question H260.

As illustrated in Example H260.1, entities will frequently pay commissions for initial contracts that are significantly greater than the commissions they will pay for contract renewals. In Example H260.1, the entity (CSP) pays a 5% commission for the initial contract and only a 1% commission for each renewal of that contract.

In Scenario 2 (which is likely to be an uncommon scenario), where the 1% renewal commission is determined to be 'commensurate' with the initial 5% commission, the amortization period for the 5% initial contract commission does *not* include the two specifically anticipated one-year renewal periods. Consequently, the 5% initial contract commission is amortized in its entirety over the initial one-year contract term consistent with the CSP's provision of the cloud-based services to its customers.

In Scenarios 1 and 3, the amortization period for the initial contract acquisition cost asset includes the two specifically anticipated one-year renewal periods because the 1% renewal commission is not 'commensurate with' the 5% initial contract commission. Consequently, we believe CSP could either (and disclose its policy in this regard):

— amortize the *entire* 5% initial contract commission over the initial contract period *plus* the two specifically anticipated renewal periods, which, assuming a time-elapsed or time-based measure of progress for the SaaS, would result in recognizing more sales expense during the two renewal periods. That is, during each of the two renewal periods, CSP will, in addition to amortizing the initial contract commission asset, also be amortizing the 1% renewal commission (unless CSP is permitted, and chooses, to elect the practical expedient for the renewal commissions); or

— amortize only the *portion* of the initial contract commission that is determined to be 'incremental' to the renewal commission over the initial contract period plus the two specifically anticipated renewal periods, while recognizing the remainder of the initial contract commission over only the initial one-year contract period (**Note**: it would not be permissible to apply the one-year practical expedient to that portion of the overall initial commission). Applied to Scenarios 1 and 3, this would result in recognizing equal contract cost amortization (i.e. sales expense) during the initial and the two anticipated renewal periods (i.e. assuming CSP uses a time-elapsed or time-based measure of progress for the SaaS and CSP is not permitted to apply, or does not elect, the practical expedient for the renewal commissions).

We believe an entity's decision in this regard is an accounting policy election that should be disclosed in accordance with paragraph 340-40-50-2. Example H300.1 illustrates an application of both of the above approaches.

Question H280

Can a contract cost asset be allocated solely to a good or service (or bundle of goods and services) that is not distinct?

Interpretive response: No. We do not believe an entity can allocate a contract cost asset to a good or service (or bundle of goods and services) if that good or service (or bundle) is not distinct. If a good or service (or bundle of goods and services) is not distinct from the other goods or services in the contract, the economic benefits and costs associated to that good or service are not separately identifiable from the economic benefits and costs of the other goods and services from which it is not distinct. Consequently, amortization of a contract cost asset should be on a systematic basis based on the expected attribution of the distinct goods or services (which may include a bundle of goods or services, or distinct goods or services that are part of a single performance obligation in accordance with the series guidance in paragraph 606-10-25-14(b)) to which it relates (which may include distinct, anticipated goods or services), only. If the distinct good or service to which the (or a portion of the) contract cost asset relates is transferred to the customer over time, the entity must use a single measure of progress to amortize the contract cost asset that is consistent with its single measure of progress used to recognize revenue on the related performance obligation.

Question H290

If a contract cost asset relates to more than one distinct good or service, is the entity required to allocate that asset among those distinct goods or services?

Interpretive response: No. While it is always acceptable to allocate a contract cost asset among the distinct goods or services to which it relates (see Question H300), the members of the TRG generally concluded that it would also be reasonable to amortize a contract cost asset using a single measure of progress considering all of the distinct goods or services to which the asset relates.

In the view of most TRG members, this approach may be more operable for some entities since it would not require the entity to undertake an allocation exercise for contract costs within a contract. In TRG agenda paper No. 23 outlining this view, the FASB and IASB staffs expressed that (1) they did not believe this approach should result in a significantly different pattern of amortization of the contract cost asset from that which would result from allocating the asset to all of the distinct goods or services to which it relates and (2) that use of the 'single measure' approach would not change an entity's requirement to consider anticipated future contracts (e.g. contract renewals) when determining the goods or services to which the contract cost asset relates (i.e. the amortization period for the asset).

When determining a single measure of progress to apply to amortization of a contract cost asset, we believe entities would look to the guidance in Topic 606 for determining an appropriate measure of progress to apply to a performance obligation satisfied over time (paragraphs 606-10-25-31 through 25-37 and paragraphs 606-10-55-16 through 55-21), which is discussed in *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*. A measure of progress that would not be acceptable for recognizing revenue on the goods or services to which the asset relates if they were a single performance obligation also would not be acceptable in amortizing a contract cost asset. Consistent with determining a single measure of progress for a combined performance obligation satisfied over time, determining a single measure of progress for a contract cost asset that relates to multiple goods or services (whether those goods or services are a single performance obligation or separate performance obligations) may require significant judgment and there may be more than one acceptable measure of progress that could be selected.

We would expect an entity to either allocate contract cost assets among the distinct goods or services (or bundles of distinct goods or services) to which they relate or use a single measure of progress approach consistently in similar circumstances.

Question H295

If an entity uses the single measure of progress approach to amortize contract cost assets that relate to multiple distinct goods or services, would straight-line amortization be appropriate?

Interpretive response: It depends. As discussed in Question H290, an entity is not required to allocate contract cost assets to each distinct good or service to which they relate. However, if the entity does not allocate a contract cost asset to each distinct good or service to which it relates, it nonetheless uses a single measure of progress that is consistent with the transfer to the customer of the goods or services to which the contract cost asset relates. [340-40-35-1]

For example, if a significant amount of revenue and/or margin will be recognized at or near contract inception, we believe the amortization approach should also recognize a commensurate portion of the cost upfront. That is, it is inappropriate not to recognize expense upfront when a significant portion of the economic benefits expected to be derived from the contract cost asset *are* recognized upfront (e.g. a time-based amortization method would be inappropriate).

Example H295.1
Allocation and amortization of contract cost assets (1)

ABC Corp. enters into a contract with Customer to provide a two-year license to Customer for its off-the-shelf software (Product H) and to provide technical support services and updates, upgrades and enhancements developed for the two-year term (collectively, PCS). The total, fixed transaction price is $100,000. ABC pays a commission of $20,000 to its salesperson for obtaining the contract (assume no renewals are expected).

The PCS is determined to be a single performance obligation (see Question C150). The software license and PCS are determined to be separate performance obligations (see Questions C160 and C170). The software license is transferred to Customer at contract inception, and the PCS has a two-year term commencing on transfer of control of the license. Additionally:

- The relative stand-alone selling prices of the Product H software license and the PCS are $80,000 (80% of transaction price) and $20,000 (20% of transaction price), respectively.
- The gross margin ABC expects to earn on the software license is $76,000, and ABC expects to earn a margin of $8,000 each year on the PCS.

ABC has elected to not allocate contract cost assets to the separate performance obligations in arrangements of this nature. Instead, ABC will amortize the contract cost asset using one measure for the transfer of the goods or services to which the contract cost asset relates. In considering whether an output or input method best achieves this objective, ABC concludes that an output-based method will result in the most faithful depiction of its realization of the expected economic benefits from the contract cost asset. An input-based method would not meet this objective because the incremental cost to transfer the Product H license is virtually nil.

On transfer of control of the Product H license, ABC amortizes $16,000 of the $20,000 initial contract cost asset. $16,000 is 80% of the contract cost asset ($16,000/$20,000 = 80%), which is equal to the percentage of the transaction price allocated to the Product H license ($80,000/$100,000 = 80%). ABC concludes that the relative stand-alone selling price is a reasonably faithful depiction of the value to Customer of the Product H license relative to the PCS. The remaining balance of the contract cost asset of $4,000 will be amortized over the two-year PCS period on a time-elapsed output basis. Time elapsed faithfully depicts the value to the customer of the PCS services over the two-year PCS period.

Other measures may also be acceptable provided that they result in amortization of the contract cost asset that is generally consistent with the pattern of transfer to the customer of the goods or services to which the asset relates. For example, ABC could amortize the contract cost asset in proportion to the gross margin to be recognized.

It would not be appropriate in this example for ABC to amortize the entire contract cost asset on a straight-line basis, i.e. using a time-based or time-elapsed measure over the two-year PCS period (e.g. $10,000 per year) without amortizing a significant portion of the contract cost asset upfront, because the resulting recognition of expense would not be consistent with the transfer to the customer of the goods or services to which it relates.

Question H300

What approaches are acceptable for allocating a contract cost asset to the distinct goods or services to which it relates?

Interpretive response: Subtopic 340-40 (paragraph 340-40-35-1) requires a contract cost asset to be amortized on a systematic basis (which is not necessarily on a straight-line basis) that is 'consistent with the transfer to the customer of the goods or services to which the asset relates'. As outlined in Question H290, this may be accomplished by allocating the contract cost asset among the distinct goods or services to which it relates or by applying a single measure of amortization considering the pattern of transfer of all of the distinct goods or services to which the asset relates.

If an entity chooses to allocate a contract cost asset, there may be multiple acceptable approaches to doing so. This is because the amortization guidance in Subtopic 340-40 is not specific in this respect. However, whatever approach is used should be applied consistently to similar circumstances.

Relative stand-alone selling price approach

An entity would generally be permitted to allocate a contract cost asset on a relative stand-alone selling price basis. If there are not specifically anticipated renewals (see Question H250), the relative allocation of the contract cost asset would follow the allocation of the transaction price to the performance obligations (or distinct goods or services) in the contract.

However, additional complexity will arise if renewals of a good or service are specifically-anticipated *and* the entity does not pay commissions on contract renewals that are 'commensurate' with the commissions it pays on initial contracts (see Question H260). This is because the goods or services to which the contract commission being evaluated relates include those anticipated renewals.

So, for example, assume an entity enters into a contract for a perpetual software license and one year of bundled PCS. The entity anticipates the customer will renew PCS for three additional annual periods, but does not pay a commission for PCS renewals. In that case, the entity will allocate the initial contract commission asset to the software license and *four* annual PCS periods on a relative stand-alone selling price basis. If the entity pays a non-commensurate commission for PCS renewals, those expected renewal commissions are factored into the allocation of the initial contract commission asset. Example H300.1 illustrates this scenario (Alternative 1).

Alternative approaches

The following represent alternative approaches we believe *could* be acceptable depending on the facts and circumstances (not necessarily all-inclusive):

- **Economic benefits based allocation** – Rather than allocating a contract cost asset to distinct goods or services on the basis of their stand-alone selling price, it may be appropriate to consider the economic benefits (e.g. the margin) the entity expects to obtain from transferring the good or service. For example, two goods or services may have equal stand-alone selling prices, but very different margins, and given that an entity generally pays a commission in order to obtain future economic benefits in the form of the margin it earns from providing the goods or services to which the commission relates, we would generally view it as reasonable to allocate the commission in that case to the related goods or services on a relative margin basis. Consistent with the relative stand-alone selling price approach, the entity would factor margin that will be earned from specifically anticipated renewals for which commensurate commissions are not paid into the allocation approach. This approach is illustrated by Alternative 2 in Example H300.1.
- **Specific allocation basis** – There may be circumstances in which an entity can objectively determine that a contract cost asset, whether a fulfillment cost or an acquisition cost, relates specifically to one or more distinct goods or services in a contract, but not all. In that case, it may be reasonable to allocate the contract cost asset entirely to that (or those) distinct goods or services. The evaluation of whether a contract cost relates specifically to a distinct good(s) or service(s) might be similar to that an entity undertakes in determining if a variable payment relates specifically to the entity's efforts to satisfy a performance obligation or transfer a distinct good or service as described in paragraph 606-10-32-40(a). *Chapter E – Step 4: Allocate the transaction price to performance obligations in the contract* includes discussion of the guidance in paragraph 606-10-32-40.

Example H300.1
Allocation and amortization of contract cost assets (2)

ABC Corp. enters into a contract with XYZ, Inc. (XYZ) to license its software on a perpetual basis. ABC also agrees to provide technical support and unspecified updates/upgrades for two years. Those services auto-renew on an annual basis after the initial two-year term. The total, fixed transaction price is $280,000. Assume that the technical support and unspecified update/upgrade rights are determined to be a single PCS performance obligation (see Question C150). ABC pays a commission of $28,000 to its sales person for obtaining the contract.

Customers generally incur a significant cost and effort to change software solutions and generally maintain PCS for at least five years. Consequently, ABC anticipates XYZ will renew PCS for three additional years after the initial two-year PCS period. ABC sales personnel are paid a commission for obtaining a PCS renewal of 2% of the renewal fees.

The license and PCS are determined to be separate performance obligations. ABC has determined that the software license represents a license to functional IP. The license is transferred to the customer at contract inception and the two-year PCS term commences upon transfer of control of the license. In addition, the following facts are relevant:

— The relative stand-alone selling prices of the license and the initial two-year PCS are $200,000 and $80,000, respectively.
— The contractual fee for each anticipated PCS renewal is $40,000.
— The margin ABC expects to earn on the license is $180,000, while ABC expects to earn a margin of $24,000 each year that it provides PCS.

Assume there is no 'significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates' – i.e. XYZ renews PCS as anticipated and does not elect to renew PCS at the end of Year 5.

Alternative 1 – ABC elects to allocate the capitalized contract cost asset on a relative stand-alone selling price basis. Looking solely to the relative stand-alone selling prices of the license and two years of PCS in the enforceable contract, $20,000 of the capitalized contract cost asset would be allocated to the license and $8,000 would be allocated to the PCS. However, because the benefits (i.e. margin) ABC will earn from each year of promised and anticipated PCS are the same, the $800 commission that to be paid on each of the anticipated PCS renewals is not commensurate with the commission for the initial, promised two-year PCS.

Consequently, ABC aggregates the initial commission of $28,000 and the expected renewal commissions of $2,400 ($800 for each of the three anticipated annual renewals) and allocates them on the following basis to the license and the expected PCS.

Good or service	**Relative stand-alone selling price**	**% allocation**	**Allocation of expected commissions**
License	$200,000	50%	$15,200
2-year initial PCS	80,000	20%	6,080
Year 3 renewal PCS	40,000	10%	3,040
Year 4 renewal PCS	40,000	10%	3,040
Year 5 renewal PCS	40,000	10%	3,040
	$400,000	**100%**	**$30,400**

At contract inception, ABC becomes obligated to pay a commission of $28,000. Because control of the software license transfers to XYZ at contract inception, ABC expenses $15,200 of the $28,000 commission cost, and recognizes a contract cost asset of $12,800. ABC amortizes $6,080 of that contract cost asset to sales expense over the two-year initial PCS term, leaving a remaining balance of $6,720 at the end of Year 2. At the beginning of each of Years 3 through 5, ABC adds to the contract cost asset by $800 (for each PCS renewal commission), while amortizing $3,040 of that contract cost asset to sales expense during each of those years.

Alternative 1(a) – The conclusion in Question H270 permits a variation of the accounting outlined in the preceding paragraph. Following the discussion in that question, it would also be permissible for ABC to amortize the initial contract cost asset of $12,800 ($28,000 commission – $15,200 allocated to the software license) over the expected 5-year PCS term ($2,560 per year). This would result in ABC recognizing $2,560 in amortized sales expense in each of Years 1 and 2, but recognizing $3,360 of such expense in each of Years 3-5 ($2,560 + $800 = $3,360).

Alternative 2 – ABC elects to allocate the capitalized contract cost asset on a relative margin basis. Consistent with Alternative 1, ABC concludes that the $800 commission that will be paid on each of the anticipated PCS renewals is not commensurate with the commission for the initial, promised two-year PCS.

Consequently, ABC aggregates the initial commission of $28,000 and the expected renewal commissions of $2,400 ($800 for each of the three anticipated annual renewals) and allocates them on the following basis to the license and the expected PCS.

Good or service	Relative margin	% allocation	Allocation of expected commissions
License	$180,000	60%	$18,240
2-year initial PCS	48,000	16%	4,864
Year 3 renewal PCS	24,000	8%	2,432
Year 4 renewal PCS	24,000	8%	2,432
Year 5 renewal PCS	24,000	8%	2,432
	$300,000	**100%**	**$30,400**

At contract inception, ABC becomes obligated to pay a commission of $28,000. Because control of the software license transfers to XYZ at contract inception, ABC expenses $18,240 of the $28,000 commission cost, and recognizes a contract cost asset of $9,760 ($28,000 commission – $18,240 allocated to the software license). ABC amortizes $4,864 of that contract cost asset to sales expense over the two-year initial PCS term, leaving a remaining balance of $4,896 at the end of Year 2. At the beginning of each of Years 3 through 5, ABC adds to the contract cost asset by $800 (for each PCS renewal commission), while amortizing $2,432 of that contract cost asset to sales expense each of those years.

Alternative 2(a) – Consistent with Alternative 1(a), a variation of the accounting outlined in the preceding paragraph would be for ABC to amortize the initial contract cost asset of $9,760 over the expected 5-year PCS term ($1,952 per year). This would result in ABC recognizing $1,952 in amortized sales expense in each of Years 1 and 2, but recognizing $2,752 of such expense in each of Years 3-5 (i.e. $1,952 + the $800 commission specific to that year's PCS renewal = $2,752).

Question H310

Is a contract cost asset amortized consistent with the expected pattern of transfer of the related good or service or the expected pattern of revenue recognition?

Interpretive response: Subtopic 340-40 prescribes that a contract cost asset be amortized on a systematic basis consistent with the transfer to the customer of the goods or services to which the asset relates. The expected pattern of *revenue recognition* for a good or service, which may differ from the pattern of *transfer* to the customer of that good or service if the consideration to which the entity expects to be entitled is variable, does not affect the amortization of a contract cost asset. By way of example, assume a software entity agrees to transfer a distinct software license in exchange for a sales- or usage-based royalty. The *portion* of any contract cost asset that relates to the distinct software license should be fully expensed upon transfer of control of that license, without regard to when the entity expects to be able to recognize expected sales- or usage-based royalties.

It is important to remember, however, that a portion of the total contract cost asset in the preceding example may relate to other promised goods or services (e.g. PCS or hosting services), including goods or services that will be provided under one or more specifically anticipated contracts (e.g. expected PCS or hosting services renewals). Unless a single measure of progress approach is used for amortization of the contract cost asset (see Question H290) only the portion of the contract cost asset that relates to the distinct software license is expensed upon transfer of control of that license; the remainder is amortized consistent with the transfer of the other goods or services to which it relates.

Question H320

Are sales- and usage-based royalties included in 'the consideration' (paragraph 340-40-35-3(a)) when considering contract cost asset impairment?

Interpretive response: Yes, 'the consideration' in paragraph 340-40-35-3(a) includes the entity's *unconstrained* estimate (based on paragraphs 606-10-32-5 through 32-9) of all variable consideration, including sales- and usage-based royalties, to which it expects to be entitled, reduced for any such amounts it does not expect to receive (i.e. collect) from the customer.

In some circumstances (e.g. where the license is not distinct or is not transferred at the beginning of the contract, and a significant portion of the contract fees are in the form of a sales- or usage-based royalty) this may require an entity to estimate expected sales- or usage-based royalties to assess impairment of a contract cost asset when it otherwise would not be required to estimate those amounts for purposes of revenue recognition or disclosure purposes (e.g. if the entity must apply the guidance on allocation of variable consideration or is able to apply the 'as-invoiced' recognition practical expedient in paragraph 606-10-55-18).

Question H330

Is the amortization period and pattern for contract cost assets and the revenue recognition pattern for nonrefundable upfront fees symmetrical?

Interpretive response: No. The amortization period and the amortization pattern for contract cost assets and the revenue recognition pattern for nonrefundable upfront fees are not symmetrical under Subtopic 340-40 and Topic 606.

The revenue recognition pattern for nonrefundable upfront fees is based on the existing contract plus any renewals for which the initial payment of the upfront fee provides a material right to the customer. Therefore, the recognition period and recognition pattern for these items may not align, even if the contract cost asset and nonrefundable upfront fees are related to the same contract. [606-10-55-50 – 55-53]

Comparison to legacy US GAAP

Amortization of contract fulfillment costs decoupled from nonrefundable upfront fees

Legacy SEC guidance on revenue recognition required registrants to defer nonrefundable upfront fees if they were not in exchange for goods or services performed that represented the culmination of a separate earnings process. These fees were deferred and recognized as revenue over the expected period of performance, which may have included expected renewal periods if the expected life of the contract extended beyond the initial period. Similarly, the guidance allowed an entity to elect an accounting policy of deferring certain set-up costs or customer acquisition costs. [SAB Topic 13]

If the amount of deferred upfront fees exceeded the deferred costs, then these two amounts were recognized over the same period and in the same manner. However, if the amount of deferred costs exceeded the deferred revenue from upfront fees, then legacy practice was somewhat mixed and some entities amortized the net deferred costs over the shorter of the estimated customer life and the stated contract period. [SAB Topic 13]

Topic 606 and Subtopic 340-40 effectively decouples the amortization of contract fulfillment costs from that for any nonrefundable upfront fees in the contract. The capitalization of qualifying fulfillment costs is not a policy election. The amortization period for contract cost assets is determined in a manner substantially similar to that under the legacy guidance when upfront fees result in an equal or greater amount of deferred revenue – i.e. the existing contract plus anticipated renewals that the entity can specifically identify. However, contract costs that were previously deferred without corresponding deferred revenue may be amortized over a longer period under Subtopic 340-40 than under legacy US GAAP.

Question H340

Are the remaining estimated contract costs used in the impairment assessment discounted?

Interpretive response: Possibly, in some cases. For certain long-term contracts that have a significant financing component, the estimated transaction price may be discounted (see Chapter D – Step 3: Determine the transaction price; The existence of a significant financing component in the contract).

Topic 606 does not prescribe whether to discount the estimated remaining costs of directly providing those goods or services when performing the impairment test. Even though the contract cost asset is not presented on a discounted basis in the entity's balance sheet, an entity's decision about whether to discount estimated remaining costs of providing the goods or services should be consistent with the measurement of the remaining transaction price.

Question H350

How often does an entity assess its contract cost assets for impairment?

Interpretive response: Subtopic 340-40 does not specify how often an entity should assess its contract cost assets for impairment. We believe, similar to assessing impairment of long-lived assets under Section 360-10-35, entities should assess the contract cost assets for impairment whenever events or changes in circumstances indicate that the carrying amount of a contract cost asset may not be recoverable.

Such events or changes in circumstances may include the following:

- contract modifications, including changes in price, contract terminations, and scope changes;
- changes in expectations as to whether customers will renew/extend existing contracts, or specific goods or services in a contract, to which contract cost assets relate;
- changes in estimates of expected costs to fulfill one or more performance obligations in a contract; and/or
- changes in estimates of the amount of consideration that the entity expects to receive from the customer (e.g. collectibility).

Example H350.1

Impairment of a contract cost asset

SaaS Provider enters into a contract to provide Customer with access to its SaaS for three years in exchange for $200,000 per year. SaaS provider incurs $100,000 in incremental costs to obtain the contract and $80,000 in costs for customer-specific set up activities to fulfill the contract. The $180,000 of costs are capitalized and are being amortized over the three-year period which Customer will benefit.

At the end of Year 2, Customer approaches SaaS provider to renegotiate the fee, because of significant economic hardships faced by Customer. SaaS provider agrees to reduce the fee for Year 3 to $25,000 and is assessing the unamortized contract cost asset of $60,000 ($180,000 less two years of amortization, or $120,000) for impairment.

Assuming no other contract cost impairment guidance outside of Subtopic 340-40 is applicable and $15,000 of costs related to providing the final year of SaaS access, SaaS Provider impairs the contract cost asset by $50,000. This represents the difference between consideration that it expects to receive less the costs that relate directly to providing those services ($25,000 consideration less $15,000 of costs) and the unamortized contract cost asset balance ($60,000).

Applicable to all industries

Expanded disclosures

Topic 606 contains both qualitative and quantitative disclosure requirements for annual and interim periods. The objective of the disclosures is to provide sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Specifically, Topic 606 includes disclosure requirements for:

- disaggregation of revenue;
- contract balances, including changes during the period;
- performance obligations;
- significant judgments; and
- assets recognized to obtain or fulfill a contract, including changes during the period.

An entity should review these new disclosure requirements to evaluate whether data necessary to comply with the disclosure requirements are currently being captured and whether system modifications are needed to accumulate the data.

Internal controls necessary to ensure the completeness and accuracy of the new disclosures should be considered – especially if the required data was not previously collected, or was collected for purposes other than financial reporting.

Further, SEC SAB Topic 11.M requires registrants to disclose the potential effects that recently issued accounting standards will have on their financial statements when adopted. The SEC expects the level and specificity of these transition disclosures to increase as registrants progress in their implementation plans. The SEC has also stated, when the effect is not known or reasonably estimated, that a registrant should describe its progress in implementing Topic 606 and the significant implementation matters that it still needs to address.

See chapter 15 in KPMG Handbook, Revenue recognition for further discussion and analysis on disclosure requirements.

Transition

An entity can elect to adopt Topic 606 in a variety of ways, including retrospectively with or without optional practical expedients, or from the beginning of the year of initial application with no restatement of comparative periods (cumulative effect method).

Entities that elect the cumulative effect method are required to disclose the changes between the reported results of Topic 606 and those that would have been reported under legacy US GAAP in the period of adoption.

For transition purposes, Topic 606 introduces a new term – completed contract. A completed contract is a contract for which an entity has recognized all or substantially all of the revenue under legacy US GAAP as of the date of adoption of Topic 606. The concept of a completed contract is used when applying:

— certain practical expedients available during transition under the retrospective method; and
— the cumulative effect method coupled with the election to initially apply the guidance only to those contracts that are not complete.

This will require careful analysis particularly where there is trailing revenue after delivery has occurred (e.g. revenue was not fixed or determinable, collectibility was not reasonably assured, royalty arrangements). In those circumstances, the contract would not be considered complete if substantially all of the revenue had not been recognized before adoption. Applying the standard to these types of contracts at transition may result in revenue being pulled into the opening retained earnings adjustment.

Entities should consider the potential complexities involved with calculating the opening retained earnings adjustment and the recast of comparative periods (if any) when planning their implementation. It may be prudent for entities to perform transition calculations before the adoption date to ensure all potential complexities are identified.

See chapter 16 of KPMG Handbook, Revenue recognition for further discussion and analysis on transition requirements.

Effective dates

	Public entities[1]	Other entities
Effective date:	— First annual reporting period beginning after December 15, 2017. — Interim reporting periods within that annual period.	— First annual reporting period beginning after December 15, 2018. — Interim reporting periods within annual reporting periods beginning after December 15, 2019. However, if Topic 606 has not been adopted as of June 3, 2020:[2] — First annual reporting period beginning after December 15, 2019. — Interim reporting periods within annual reporting periods beginning after December 15, 2020.
Early adoption:	Permitted for: — Annual reporting periods beginning after December 15, 2016. — Interim reporting periods within that annual period.	Permitted for: — Annual reporting periods beginning after December 15, 2016. — Interim reporting periods: – within the annual reporting period of adoption; or – within the annual reporting period subsequent to the annual reporting period of adoption.

Notes:

1. This includes (1) public business entities, (2) not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and (3) employee benefit plans that file or furnish financial statements with or to the SEC.
2. This effective date applies to entities that had not issued (made available for issuance) financial statements as of June 3, 2020 reflecting the adoption of Topic 606. ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, deferred the effective date for those specific other entities by one year.

Some basic reminders

Scope

The guidance applies to all contracts with customers unless the customer contract is specifically in the scope of other guidance – e.g. Topic 944 (insurance), Topic 460 (guarantees).	Topic 606 applies to contracts to deliver goods or services to a customer. A ‘customer’ is 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. Topic 606 will be applied to part of a contract when only some elements are in the scope of other guidance.

Step 1: Identify the contract

Contracts can be written, oral or implied by an entity’s customary business practices, but must be enforceable by law. This may require legal analysis on a jurisdictional level to determine when a contract exists and the terms of that contract’s enforceability.	A contract with a customer is in the scope of Topic 606 when the contract is legally enforceable and all of the following criteria are met: — the contract has commercial substance; — rights to goods or services can be identified; — payment terms can be identified; — the consideration the entity expects to be entitled to is probable of collection; and — the contract is approved and the parties are committed to their obligations. If the criteria are not met, any consideration received from the customer is generally recognized as a deposit (liability).

Step 2: Identify the performance obligations

Performance obligations do not have to be legally enforceable; they exist if the customer has a reasonable expectation that the good or service will be provided.

A promise can be implied by customary business practices, policies or statements.

Performance obligations are the unit of account under Topic 606 and generally represent the distinct goods or services that are promised to the customer.

Promises to the customer are separated into performance obligations, and are accounted for separately if they are both (1) capable of being distinct and (2) distinct in the context of the contract.

If the distinct goods or services are substantially the same and have the same pattern of transfer to the customer over time, they are combined into a single performance obligation (a 'series').

Step 3: Determine the transaction price

Estimating variable consideration is a new challenge for many entities.

When determining the transaction price, an entity uses the legally enforceable contract term. It does not take into consideration the possibility of a contract being canceled, renewed or modified.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. some sales taxes. This consideration can include fixed and variable amounts, and is determined at inception of the contract and updated each reporting period for any changes in circumstances.

The transaction price determination also considers:

— **Variable consideration**, which is estimated at contract inception and is updated at each reporting date for any changes in circumstances. The amount of estimated variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.

- **Noncash consideration** received from a customer is measured at fair value at contract inception.
- **Consideration payable to a customer**, which represents a reduction of the transaction price unless it is a payment for distinct goods or services it receives from the customer.
- **Significant financing components**, which may exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.

Step 4: Allocate the transaction price

A contractually stated price or list price is not presumed to be the stand-alone selling price of that good or service.

The transaction price is allocated at contract inception to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. Observable stand-alone prices are used when they are available. If not available, an entity is required to estimate the price using other techniques and maximizing the use of observable inputs – even if the entity never sells the performance obligation separately.

Step 5: Recognize revenue

An entity first determines whether a performance obligation meets the criteria to recognize revenue over time.

If none of the over-time criteria are met, revenue for the performance obligation is recognized at the point in time that the customer obtains control of the goods or services.

Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods or services – or prevent others from doing so.

An entity recognizes revenue when it satisfies its obligation by transferring control of the good or service to the customer.

A performance obligation is satisfied ***over time*** if one of the following criteria are met:

— the customer simultaneously receives and consumes the benefits as the entity performs;

— the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or

— 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.

If control transfers ***over time***, an entity selects a method to measure progress that is consistent with the objective of depicting its performance.

If control transfers at a ***point in time***, the following are some indicators that an entity considers to determine when control has passed. The customer has:

— a present obligation to pay;
— physical possession;
— legal title;
— risks and rewards or ownership; and
— accepted the asset.

Customer options

Customer optionsare accounted for as performance obligations if they grant the customer a material right.	Revenue is allocated to a customer option to acquire additional goods or services, and is deferred until (1) those future goods or services are transferred or (2) the option expires when it represents a material right. A material right exists if the customer is only able to obtain the option by entering into the sale agreement and the option provides the customer with the ability to obtain the additional goods or services at a discount that is incremental to a discount typically given to that class of customer. If the option is not a material right, it is considered a marketing offer that is accounted for separately.

Warranties

Warranties do not have to be separately priced to be accounted for as performance obligations.	Assurance-type warranties will generally continue to be accounted for under existing guidance – i.e. Topic 450, *Contingencies*. However, a warranty is accounted for as a performance obligation if it includes a service beyond assuring that the good complies with agreed-upon specifications. This could require some warranties to be separated between a service element (deferral of revenue which is then recognized as the services are provided) and an assurance element (cost accrual at the time the good is transferred).

Principal vs. agent

Determining whether an entity is the principal or an agent when another party is involved in providing a good or service focuses on whether the entity controls the specified good or service before it is transferred to the customer.

An entity identifies each specified good or service to be transferred to the customer, and determines whether it is acting as a principal or agent for each one. In a contract to transfer multiple goods or services, an entity may be a principal for some goods and services and an agent for others.

An entity is a principal if it 'controls' the specified good or service that is promised to the customer before it is transferred to the customer.

Indicators that an entity has obtained control of a good or service before it is transferred to the customer are:

- having primary responsibility to provide specified goods or services;
- assuming inventory risk; and
- having discretion to establish prices for the specified goods or services.

The indicators are not evaluated in isolation as either a separate or an additional assessment from that of the control principle. Rather, the indicators should be considered in the context of the control principle, with more weight given to those indicators that provide more relevant evidence about whether the entity has the ability to direct the use of, and obtain substantially all the remaining benefits from, the specified good or service before it is transferred to the customer.

Contract modifications

Topic 606 has a general framework to account for contract modifications, which are accounted for either on a cumulative catch-up basis or a prospective basis.

If any additional distinct goods or services are not priced at their stand-alone selling prices, the remaining transaction price is required to be reallocated to all unsatisfied performance obligations, including those from the original contract.

Topic 606 requires an entity to account for modifications either on a cumulative catch-up basis (when the additional goods or services are not distinct) or a prospective basis (when the additional goods or services are distinct).

Contract costs

Subtopic 340-40 provides guidance on costs to obtain and fulfill a contract in the scope of Topic 606.	Subtopic 340-40 provides guidance on the following costs related to a contract with a customer that is in the scope of Topic 606: — incremental costs to obtain a contract; and — costs incurred in fulfilling a contract that are not in the scope of other guidance. Incremental costs to obtain a contract with a customer (e.g. sales commissions) are required to be capitalized if an entity expects to recover those costs – unless the amortization period, which may include anticipated contracts or renewals, is less than 12 months.
The fulfillment cost guidance only applies when the costs are not in the scope of other guidance.	Fulfillment costs that are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant, and equipment – are capitalized if the fulfillment costs: — relate directly to an existing contract or specific anticipated contract; — generate or enhance resources that will be used to satisfy performance obligations in the future; and — are expected to be recovered.
Capitalization is required when the criteria are met.	An entity amortizes the assets recognized for the costs to obtain and/or fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates.

Index of changes

This table lists all of the significant additions and changes made in this edition to assist you in locating recently added or updated content. New Questions and Examples added in this edition are identified throughout the Handbook with ** and items that have been significantly updated or revised are identified with #.

A. **Scope**

Question

A60 Can an entity record proceeds received from the settlement of a patent infringement with another party as revenue? #

C. **Step 2: Identify the performance obligations in the contract**

Question

C170 How does a software vendor evaluate whether a software license is distinct from a promise to provide unspecified updates, upgrades and enhancements? #

Example

C170.3 Software license and updates (2) **

D. **Step 3: Determine the transaction price**

Question

D350 Are payments to customers in the form of equity-based instruments, instead of cash, considered 'consideration payable to a customer'? #

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

Questions

E135 Can the stand-alone selling prices of a software license and PCS both be expressed as percentages of the transaction price? **

E140 How can an entity estimate the stand-alone selling prices of software term licenses and PCS sold together as a bundle? #

E145 What effect does software being 'open-source' have on allocating transaction price between a software license and co-terminus PCS? **

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