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Technical Line

FASB — final guidance

How the new revenue standard affects technology entities

In this issue:

What you need to know

- The new standard may change the timing of revenue recognition for technology entities. For example, it may require earlier recognition of revenue from term-based software licenses than legacy guidance.
- Identifying the promises in a contract, evaluating whether they are separate performance obligations and allocating the transaction price to the identified performance obligations may require significant analysis and judgment.
- Applying the new standard requires changes to an entity's accounting policies, processes and internal controls and may require changes to its information technology systems. Many entities are finding that implementation requires significantly more effort than they expected, even when accounting effects are not significant.

Overview

The 2018 effective date[1] of the new revenue recognition standard[2] issued by the Financial Accounting Standards Board (FASB or Board) is fast approaching. As they work on implementation, technology entities need to make sure they consider all developments. For example, the FASB amended its new revenue recognition guidance on accounting for licenses of intellectual property (IP), identifying performance obligations, evaluating whether an entity is a principal or an agent, assessing collectibility and measuring noncash consideration. In addition, the Joint Transition Resource Group for Revenue Recognition (TRG)[3] generally agreed on several issues that may affect the technology industry.

Building a better working world

This publication highlights key aspects of applying the FASB's standard to technology contracts, addresses certain changes from legacy practice and reflects the latest implementation insights. Entities also may want to monitor developments as the software task force[4] formed by the American Institute of Certified Public Accountants (AICPA) addresses implementation issues.

This publication, which contains a summary of the standard in Appendix A, supplements our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*, and should be read in conjunction with it. The views we express in this publication may continue to evolve as implementation continues and additional issues are identified.

Because the standard provides specific guidance on the recognition of revenue from licenses of IP, it will be important for entities to determine whether a contract contains a license of IP. Therefore, this publication starts with a section on evaluating whether a contract contains a license of IP and then addresses the new accounting guidance required by the standard for licenses of IP. It is important to note that entities with licenses of IP will still follow other aspects of the standard's five-step model for contracts because the licensing guidance does not address all aspects of the new model. Therefore, the sections of this publication on identifying performance obligations and additional considerations apply to all technology contracts, including those that contain licenses of IP.

Licenses of IP

The standard provides guidance on the recognition of revenue from licenses of IP that goes beyond the recognition model for other promised goods and services. When applying the guidance on licenses of IP, a technology entity analyzes the facts and circumstances of each contract (or type of contract) and may need to use more judgment than it did under legacy GAAP. The units of accounting and timing of revenue recognition also may change.

Determining whether a contract contains a promise of a license

Technology contracts can include software as a service (SaaS), cloud computing or hosted software (collectively referred to as SaaS throughout this publication), licenses of software that are run from servers on the customer's premises (often referred to as on-premises software or on-premise software), hardware, networking equipment or a mix of these goods and services. Technology entities often sell updates to licensed software that are transferred on a when-and-if-available basis, bug fixes and telephone support (collectively referred to as post-contract customer support or PCS). Technology entities also offer professional services ranging from information technology (IT) consulting services to technical support services.

To apply the revenue standard, technology entities first need to determine whether a contract includes a promise of a license of IP. This assessment may be straightforward for contracts that include licenses of on-premise software, but entities have to carefully evaluate the contractual rights in contracts that include hosting services.

The criteria for making this assessment in hosted arrangements were carried forward from Accounting Standards Codification (ASC) 985, *Software*. A separate promise of a license exists when: (1) the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty, and (2) the customer can run the software on its own hardware or contract with another party unrelated to the vendor to host the software.[5] If both criteria are met, a separate promise of a license exists in the contract. The FASB emphasized in the Background Information and Basis for Conclusions of Accounting Standards Update (ASU) 2016-10[6] that a contract must include a license of IP in order for an entity to apply the licensing guidance in the standard.

Determining whether a license is distinct

After determining that a contract includes a license of IP, a technology entity must determine whether the license and additional goods and services are distinct. To be distinct, a license must be both (1) capable of being distinct and (2) separately identifiable (i.e., distinct within the context of the contract).

A license is capable of being distinct if a customer can benefit from the license either on its own or together with other resources that are readily available to the customer. If a license is capable of being distinct, it is evaluated to determine whether it is distinct within the context of the contract (i.e., whether the nature of the promise is to transfer the license and the other goods or services individually or to transfer a combined item or items whose inputs are the license and the other promised goods or services).

Consider Example 11, Case A,[7] in the standard, which describes a contract for a software license that is transferred along with installation services, technical support and software updates. The installation service is routinely performed by other entities and does not significantly modify the software. The software license is delivered before the other goods and services and can continue to function without the updates and technical support. The customer can benefit from the technical support and updates together with the software license transferred at the outset of the contract. The entity concludes that the customer can benefit from each of the goods and services either on its own or together with other goods or services that are readily available.[8] That is, each good or service, including the software license, is capable of being distinct under ASC 606-10-25-19(a).

Determining whether a license is distinct may require significant judgment.

The entity then considers the factors in ASC 606-10-25-21 and determines that the promise to transfer each good and service, including the software license, is distinct within the context of the contract. In reaching this determination, the entity notes that the installation services are routine and can be obtained from other providers, and software updates and technical support aren't necessary for the software to maintain a high level of utility to the customer during the license period. Therefore, the installation services, software updates and technical support do not significantly affect the customer's ability to use and benefit from the software license.

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 services into one combined output. Lastly, the software and the services are not deemed to be highly interdependent or highly interrelated because the entity can fulfill its promise to transfer the initial software license, regardless of whether it fulfills its promises to provide the installation service, software updates and technical support. As a result, the entity identifies four performance obligations: the software license, the installation services, the technical support and the software updates.

When a license of IP is not distinct, it is combined with other goods and services as a single performance obligation. Consider Example 10, Case C,[9] in the standard. In this example, the entity grants a customer a three-year term license to antivirus software and promises to provide the customer with unspecified updates to that software during the license period when and if they become available. 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 contract. The entity concludes that its promises to transfer the software license and to provide the updates, when and if available, are not distinct within the context of the contract in accordance with ASC 606-10-25-19(b) because the license and the updates are, in effect, inputs to a combined item (i.e., antivirus protection) promised to the customer 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) and are accounted for as a single performance obligation.

How we see it

Many software contracts are not directly analogous to the two examples the standard provides of how to evaluate whether to combine a license and unspecified updates into a single performance obligation. Each software entity needs to evaluate the specific terms of its contracts to determine whether the license should be combined with the unspecified updates or other promises in the contract. We believe that to reach a conclusion that a license and unspecified updates are not distinct within the context of the contract, an entity generally would need to demonstrate that providing the updates will significantly affect the utility of the software license.

Determining whether the license in a hybrid-SaaS contract is distinct

Hybrid-SaaS offerings combine on-premise software and SaaS and result in some functionality residing on the customer's servers (i.e., on premises) and some being accessed via the internet through the technology entity's (i.e., the vendor's) servers or through the servers of the technology entity's third party provider.

Capable of being distinct

When an entity concludes that a hybrid-SaaS contract contains a software license for the on-premise software, the software license and SaaS are often capable of being distinct because the customer can obtain some utility from the software license without the SaaS and can benefit from the SaaS with readily available resources (i.e., the software license that has already been transferred to the customer).

Distinct within the context of the contract

Determining whether the software license is distinct within the context of the contract often requires significant judgment. An entity should consider the level of interdependence and interrelationship between the software license and the SaaS promised in the contract.

In some offerings, the licensed software and the SaaS may have limited functionality on their own, but, when used together, the combined solution may contain the critical functionality required by the customer. In these contracts, the technology entity may conclude that the software license and the SaaS are highly interdependent or highly interrelated (i.e., not distinct within the context of the contract) and should be combined into a single performance obligation. For example, an entity may conclude a software license and SaaS are not distinct within the context of the contract if the software license provides limited benefit to the customer without the SaaS. In other contracts, the software license or the SaaS may have significant functionality on its own, and there may be two performance obligations.

The specific facts and circumstances of each contract have to be carefully considered. Factors that may suggest the software license and SaaS are distinct within the context of the contract include:

- The SaaS functionalities are available from other vendors.
- The software license or SaaS functionalities have utility on their own.
- The functionalities provided by the SaaS can also be performed using only the software license.

Factors that may suggest the software license and SaaS are not distinct within the context of the contract include:

- The customer obtains significant utility from the entity's integration of the software license with the SaaS.
- There are frequent and significant interactions between the software license and the SaaS (e.g., certain important tasks that are computationally intensive and can only be performed when the software is connected to the SaaS).

Vendor-specific objective evidence of fair value is no longer required

Under the standard, technology entities assess whether a promised good or service is capable of being distinct and is distinct within the context of the contract (i.e., separately identifiable from the other promises in the contract). Vendor-specific objective evidence (VSOE) of fair value is no longer required to identify the unit of accounting. This may lead to the identification of additional performance obligations and earlier recognition of revenue than under legacy software guidance because, under legacy software guidance, an entity can separately account for elements in a software licensing contract only if it has established VSOE of fair value of the undelivered element(s).

Term-based licenses are likely to be affected by this change. Under the new standard, a software vendor that provides a term-based software license bundled with coterminous PCS will determine that there are two performance obligations if it determines that each promise is distinct. Because the software license has standalone functionality, it is classified as functional IP (see the "Determining the nature of the entity's promise" section for a discussion of functional IP), and revenue is recognized at the point in time when control transfers (see the "Recognition of revenue from a license of IP" section below). Under the legacy accounting guidance for term-based licenses, by contrast, entities have typically had to combine elements in contracts that include coterminous, term-based software licenses and PCS because they have not been able to establish VSOE of fair value for the PCS. As a result, under legacy guidance, revenue for the combined element was generally recognized as delivery of the last element took place (i.e., the delivery of the PCS over the license period).

The elimination of the requirement that an entity have VSOE of fair value may not change the timing of revenue recognition for perpetual software licenses. This is because, under legacy guidance, many entities have been able to establish VSOE of fair value for PCS from standalone sales of PCS renewals (since PCS is typically sold in one-year increments), and therefore, they have accounted for the perpetual software license and PCS as separate elements.

Determining the nature of the entity's promise

Entities are required to classify IP as either functional or symbolic as part of their determination of whether to recognize the revenue associated with the license of that IP at a point in time or over time.

Functional IP

Functional IP has significant standalone functionality and derives a substantial portion of its utility (i.e., the IP's ability to provide benefit or value) from its standalone functionality. To provide the customer utility from the IP, the licensor is not required to continue to support or maintain the IP as part of its promise. Examples of functional IP include software licenses and patents. Revenue from functional IP generally is recognized at a point in time.

A software license is typically considered to be functional IP because the software has standalone functionality. That is, the customer can derive substantial benefit from the software on its own, and its functionality is not expected to change substantively as a result of the licensor's ongoing activities that do not transfer a good or service to the customer. A technology entity may promise to continue to support or maintain the software, with unspecified updates and upgrades, but these activities are generally separate promises in the contract and, therefore, do not significantly affect the functionality of the software promised to the customer. In making this assessment, entities don't consider whether a license is perpetual or for a specified term.

Symbolic IP

Symbolic IP does not have significant standalone functionality because its utility is derived from the licensor's ongoing or past support (e.g., activities that support the value of a brand name). Examples of symbolic IP include brands and trade names. Revenue from symbolic IP is recognized over time.

IFRS

IFRS 15 *Revenue from Contracts with Customers*, which the International Accounting Standards Board (IASB) developed jointly with the FASB to largely converge the revenue guidance in IFRS and US GAAP, does not require entities to classify licenses of IP as either functional or symbolic. Instead, entities that apply IFRS 15 must evaluate whether the contract requires, or the customer reasonably expects, the entity to undertake activities that significantly affect the IP to which the customer has rights. IFRS 15 also specifies that if the IP has significant standalone functionality, the customer derives a substantial portion of the benefit of that IP from that functionality and would not be significantly affected by the entity's activities, unless they change the form or functionality significantly.

Entities have to wait to recognize revenue until the beginning of a license renewal period.

The FASB and the IASB agreed that their approaches generally would result in consistent answers, but there could be differences between US GAAP and IFRS when entities license brand names that no longer have any related ongoing activities (e.g., the license to the brand name of a defunct sports team such as the Brooklyn Dodgers).

Recognition of revenue from a license of IP

The standard doesn't allow entities to recognize revenue for a license of IP before both (1) they provide the IP or make it available to the customer and (2) the beginning of the period during which the customer is able to use and benefit from the license.

Technology entities may make a copy of the software (functional IP) available to a customer (e.g., enable the customer to electronically download it) upon contract inception but prior to the start of the license period. The standard states that an entity would not recognize revenue before the beginning of the license period even if the entity provides the IP (or otherwise makes it available) before that date. Assuming that all other criteria have been met, the technology entity recognizes revenue from the software (the IP) at the point in time when the customer is able to use and benefit from the software (i.e., the start of the license period).

Consider a technology entity that enters into a contract with a customer to provide a software license for a three-year term beginning on 1 January 20X8 and then provides the customer with a key to electronically download the software on 29 December 20X7. Although the entity made a copy of the software available to the customer on 29 December 20X7, the customer does not have the right to use the licensed software until the license period begins on 1 January 20X8. Therefore, the entity recognizes revenue related to the software license on 1 January 20X8, assuming the entity has concluded that control of the license has transferred.

Extension of a term-based license

The guidance on recognizing revenue from a license of IP also applies to renewals or extensions of term-based licenses. That is, revenue related to the renewal of a license of IP may not be recognized before the beginning of the renewal period because that's when the licensee can use and benefit from the renewed license. Consider the following example:

Illustration 1 — Extension of a term-based license
Technology entity X enters into a contract with a customer for the use of a software license (License A) and PCS for a three-year period from 1 January 20X1 through 31 December 20X3 (the initial contract). On 30 June 20X2, Technology entity X and the customer agree to renew the contract for an additional three years from 1 January 20X4 through 31 December 20X6 (the extension period). Assume that the software license and unspecified updates are distinct and that Technology entity X recognizes revenue from the license at a point in time (functional IP) and from the PCS over time using a time-elapsed method. The customer has a copy of License A prior to the start of the extension period. When should Technology entity X recognize revenue from the extension of the license? Revenue from an initial license or a license renewal cannot be recognized until the beginning of the license period to which it relates because the customer cannot use and benefit from the software until then. Although the customer has a copy of the software from the initial contract, Technology entity X recognizes revenue for the renewal period on 1 January 20X4 when the customer can use and benefit from the software during the extension period.

IFRS 15 does not require an entity to recognize revenue relating to a license renewal at the beginning of the license renewal period. Accordingly, the IASB noted in the Basis for Conclusions on IFRS 15 (included in its April 2016 amendments) that entities that report under IFRS may recognize revenue for contract renewals or extensions earlier than those that report under US GAAP.

How we see it

The new guidance on license renewals changes practice for technology entities that have followed the legacy software guidance. Under the legacy guidance, technology entities recognize revenue from the extension of an active term-based license when the renewal agreement is executed, assuming all other revenue recognition criteria are met and VSOE of fair value of the undelivered element (e.g., PCS) exists. This is because the customer already has possession of and the right to use the software license to which the extension or renewal applies.

Under the new standard, the customer does not have the right to use the software license under the renewal agreement earlier than the beginning of the extension period, even though it already possesses a copy of the software. Therefore, entities have to wait until the beginning of the extension period to recognize revenue for renewals of software licenses under the new standard.

Sales- or usage-based royalties

Technology entities may enter into contracts that require the customer to pay a sales- or usage-based royalty in exchange for a software license. For example, a technology entity that licenses transaction processing software may require customers to pay a fee for each transaction processed using the software.

Revenue generated from sales- and usage-based royalties from licenses of IP are recognized at the later of when (1) the sale or usage occurs or (2) the performance obligation to which some or all of the sales- or usage-based royalty has been allocated is satisfied (in whole or in part). This guidance is known as the royalty recognition constraint. That is, an entity recognizes the royalties as revenue when (or as) the customer's sales or usage occurs, unless doing so accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty relates.

The FASB explained in the Basis for Conclusions of ASU 2016-10[10] that the guidance in ASC 606-10-55-65 through 55-65B addresses the recognition of sales- or usage-based royalties received in exchange for a license of IP, rather than when such amounts are included in the transaction price of the contract. As a result, this exception is a recognition constraint, and the constraint on variable consideration does not apply.

The standard requires an entity to apply the royalty recognition constraint to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP. When the sole or predominant item to which the royalty relates is not a license of IP, the general variable consideration guidance applies.

Technology entities need to apply judgment when determining whether to apply the royalty recognition constraint to a software license that is combined with other goods or services. An entity should not split a single royalty and apply the royalty recognition constraint to one portion of the royalty and apply the general constraint on variable consideration to the other portion.

It is important to note that the royalty recognition constraint applies only to licenses of IP for which some or all of the consideration is in the form of a sales- or usage-based royalty. Entities cannot analogize to it for other situations. For example, if consideration in a contract is in the form of a sales- or usage-based royalty but the contract does not contain a license of IP (e.g., sales- or usage-based fee in a SaaS contract that does not contain a software license), this guidance would not apply.

Estimating sales- or usage-based royalty received on a lag

Technology entities have questioned whether they can recognize revenue for sales- or usage-based royalties for licenses of IP (when applying the royalty recognition constraint) on a lag if actual sales or usage data is not available at the end of a reporting period. If the underlying sales or usage has occurred and the performance obligation to which the royalties relate has been satisfied (or partially satisfied), licensors without actual sales or usage data from the licensee need to estimate the royalties earned in the current reporting period.

The Chief Accountant of the Securities and Exchange Commission (SEC) noted in a speech[11] that because the FASB did not provide "a lagged reporting exception" in the standard, the reporting of sales- and usage-based royalties may require estimation in some circumstances. This may change practice for technology entities that have recorded revenue from royalties on a lag (i.e., in a reporting period after the underlying sales or usage occurs).

How we see it

Estimating royalties earned in the current reporting period by licensors without actual sales or usage data from the licensee requires significant judgment. Licensors that don't have this data need to implement processes and controls to collect data and develop assumptions to make a reasonable estimate. Some entities have requested more frequent reports from their customers or changes to the timing of reports so that they have actual data for some sales and need to estimate fewer sales. For example, an entity that requests sales or usage data monthly rather than quarterly would only need to estimate sales or usage in the last month of the quarter.

VSOE of fair value is no longer required to account for goods and services separately from each other.

Estimating the standalone selling price

Software entities commonly sell licenses, both perpetual and term-based, as part of bundled arrangements with PCS services, and these bundles are frequently sold at steep discounts to the list prices. In some cases (e.g., term-based license contracts), the license and PCS are not sold separately by the entities, meaning there isn't a standalone selling price based on observable inputs.

The standard requires an entity to estimate the standalone selling price for each performance obligation and allocate the transaction price to each performance obligation on a relative standalone selling price basis with limited exceptions (i.e., allocation of a discount[12] and allocation of variable consideration[13]). The FASB also stated in the Basis for Conclusions of ASU 2014-09[14] that if the good or service is sold at highly variable amounts, the most reliable way to determine the standalone selling price may be to use the residual approach. The standard states[15] that the residual approach can only be applied to contracts with multiple promised goods or services when the selling price of one or more goods or services is unknown (either because the historical selling price is highly variable (e.g., software licenses) or because the goods or services have not yet been sold (e.g., specified upgrade rights for software)), and when observable standalone selling prices exist for the other goods and services in the contract (e.g., PCS sold at a constant percentage of the net license fee).

Under the residual approach, an entity estimates the standalone selling price by deducting the sum of the observable standalone selling prices of the other performance obligations in the contract from the transaction price. That is, the residual approach is used to estimate the standalone selling price under the new standard rather than to allocate consideration, as it was used under legacy guidance.

Estimating standalone selling price in perpetual license contracts

For perpetual licenses, the first year of PCS is often included in a bundle with the license, and renewals of PCS are frequently sold on a standalone basis. It is common practice in the software industry to charge a percentage of the net perpetual license fee (e.g., 20% of the net license fee) for renewals of standalone PCS. Entities may be able to use the residual approach to estimate the standalone selling price of the perpetual license if they have sufficient evidence to support the assertion that the pricing for the perpetual license bundle is highly variable and there is an observable price for the PCS. An observable price for PCS may be established if PCS is priced at a consistent percentage of the net license fee for similar sales (e.g., sales to similar customers by class and geographical market). For example, PCS may be consistently priced at 20% of the net license fee. That is, the entity can demonstrate that the pricing relationship between the software license and the PCS is consistent across sales to similar customers (based on the observable price of the PCS established as a constant percentage of the net license fee).

Other considerations for estimating the standalone selling price of both the perpetual license and the PCS include the entity's internal pricing strategies, sales of similar goods or services by third parties or other industry pricing. The entity should prioritize the use of observable inputs in its estimates of the standalone selling price.

Estimating standalone selling price in term-based license contracts

Term-based licenses are often sold in a bundled arrangement with PCS for the contract term. In these cases, entities may not have standalone sales of either the term-based license or the PCS. In order to estimate standalone selling price for both the license and PCS in a bundled term-based license contract, entities may be able to identify a relationship between term-based licenses and perpetual licenses of the same software product and the related PCS.

For example, assume that an entity enters into a contract with a customer to provide a three-year term-based license and PCS for the license term for a total of $400,000. The entity does not have previous standalone sales for the license or PCS in these types of contracts. Using observable data from contracts for perpetual licenses of the same software product with one year of PCS and subsequent renewals of PCS, the entity concludes that there is a relationship between the software and PCS such that the PCS represents 20% of the net license fee. The entity considers this relationship in allocating between the license and PCS in the three-year term-based license contract and concludes that approximately $250,000 of the total consideration should be allocated to the license and the remaining $150,000 should be allocated to the PCS.

The amount allocated to the license in this example (i.e., $250,000) is calculated based on the following formula, where *x* is the amount to be allocated to the license: $400,000 = *x* + (20% * *x* * 3 years). The entity determines the value of the license based on the following calculation: $400,000 / 1.6 = $250,000. Since PCS will be paid annually for three years, each at an amount equal to 20% of the net license fee (i.e., *x*), the amount allocated to PCS in this formula is calculated as: (20% * *x* * 3 years), which is determined to be $150,000 once the amount of the license has been calculated.

This example demonstrates one acceptable method for estimating standalone selling price by leveraging the relationship between a license and PCS in similar sales. Entities can use other reasonable methods for estimating standalone selling price for the license and PCS in term-based license contracts. As part of these assessments, entities also can consider the estimated life of the software, the pricing strategies used to determine the prices for both perpetual and term-based licenses of the same software and third party prices for similar contracts. Regardless of the method used, entities should prioritize the use of observable data in their estimates and should apply the same approach consistently for similar contracts.

VSOE data may help an entity estimate standalone selling prices

Although VSOE of fair value of each element is no longer required, technology entities may find that they are able to use the observable data they used to calculate VSOE of fair value to estimate the standalone selling price for certain performance obligations, such as PCS and professional services.

Identifying performance obligations in technology contracts

The section below describes some of the promises that are commonly included in technology contracts and considerations for evaluating whether the promises represent performance obligations. These considerations may be relevant for all technology contracts, including those that contain a software license.

Nonrefundable up-front fees

When a customer pays an up-front fee at contract inception, a technology entity must evaluate whether the nonrefundable up-front fee relates to the transfer of a good or service. The existence of such a fee may indicate that there are promises in the contract, such as the option to renew PCS at a discounted rate or implementation/installation services that may or may not be required for the customer to use and benefit from an outsourcing or SaaS contract. That is, the existence of a nonrefundable up-front fee may indicate that the contract includes a renewal option for future goods and services at a reduced price, which an entity would need to assess to determine whether the option is a material right (i.e., another performance obligation in the contract).

In some cases, nonrefundable fees relate to activities that an entity is required to perform at or near contract inception. The entity must consider whether performing these activities transfers promised goods or services that are performance obligations in the contract. Activities that the entity must undertake to fulfill a contract (e.g., certain installation and setup costs) that do not transfer a good or service to the customer are not a promised good or service in the contract. Technology entities should consider the nature of the services being performed when making this assessment.

How we see it

The entity evaluates whether the nonrefundable up-front fee creates a material right. If the entity concludes that the nonrefundable up-front fee does not provide a material right, the fee is part of the consideration allocable to the goods or services in the contract and is recognized as the good or service to which the consideration is allocated is transferred to the customer. If an entity concludes that the nonrefundable up-front fee provides a material right, the amount of the fee allocated to the material right is recognized over the period of benefit of the fee, which may be the estimated customer life.

This contrasts with legacy guidance from SEC Staff Accounting Bulletin Topic 13, where nonrefundable up-front fees not paid in exchange for products delivered or services performed (representing the culmination of the earnings process) were deferred and recognized over the estimated customer relationship period.

Implementation services

Technology entities frequently include promises to provide implementation services to customers as part of their software or SaaS contracts (i.e., these implementation activities have been determined to transfer a service to the customer). These services, which can include loading of software, training of customer personnel and data conversion, need to be assessed using the entity's facts and circumstances to determine whether they are separate performance obligations (i.e., they are capable of being distinct and are distinct within the context of a contract).

In assessing whether implementation services are capable of being distinct, an entity first considers whether the customer can benefit from those services on their own. There is strong evidence to suggest that implementation services are capable of being distinct if third party vendors offer (or are capable of offering) implementation services for the entity's software or SaaS, or if the customer could perform these services on its own. This evidence would demonstrate that the implementation services provide benefit to the customer on their own (e.g., apart from the software or SaaS purchased from the technology entity).

If the entity concludes that the customer is not able to benefit from the implementation services on their own, the entity considers whether the customer can benefit from the services together with other readily available resources. Readily available resources include the software or SaaS from the contract if it is sold separately by the entity or if it is transferred to the customer before the implementation services. An entity should disregard any contractual limitations that prevent the customer from obtaining readily available resources from a party other than the entity when making this assessment. That is, restricting a customer from using another vendor to perform the installation services would not preclude a technology entity from determining that the implementation services are capable of being distinct.

In assessing whether the implementation services are distinct within the context of the contract, entities need to consider whether the implementation services modify or customize the software or SaaS, whether the entity is providing a significant service of integrating the software or SaaS with the implementation services into one combined output or whether the entity would be able to fulfill its promise to transfer the software or SaaS in the contract independently from its promise to provide the implementation services (i.e., whether the implementation services are highly interdependent or interrelated with the software or SaaS). This evaluation may require judgment and is based on the facts and circumstances of the entity's contracts.

Post-contract customer support or maintenance services

Many contracts involving software or SaaS also include promises to provide unspecified upgrades, updates and enhancements (collectively referred to as unspecified upgrades) along with technical customer support and bug fixes after the license period begins (collectively, PCS). Technology entities need to evaluate whether the individual services that comprise PCS are distinct and therefore separate performance obligations.

Entities also need to evaluate whether unspecified upgrades are a separate performance obligation from the software license or other services in the contract. Refer to the "Licenses of IP" section above.

When unspecified upgrades are a separate performance obligation in the contract, the technology entity needs to determine the appropriate measure of progress that best reflects the transfer of control to the customer. In doing so, technology entities need to consider the nature of the promise to the customer.

The individual services that comprise PCS may be separate performance obligations.

A promise to provide unspecified upgrades on a when-and-if-available basis is a stand-ready obligation, as discussed by the TRG.[16] That is, the nature of the entity's promise is fundamentally a guarantee to make available to the customer any upgrades it develops during the period. The FASB staff indicated[17] that the FASB didn't intend to change how entities determine what constitutes a specified or unspecified right. The TRG generally agreed that a time-based measure of progress (e.g., straight-line) during the period when the customer has rights to the unspecified upgrades generally would be appropriate if the customer consumes and benefits from the promise throughout the contract period.

In situations where bug fixes and technical customer support are provided outside of PCS to make sure the product functions as promised, they may be part of the assurance warranty coverage and therefore would not be revenue elements. Such warranties are accounted for under ASC 460-10, *Guarantees — Overall*. If the technology entity determines that the bug fixes or customer support (or both) are not part of the assurance warranty, it needs to determine whether they are separate performance obligations and whether the nature of the promise is a stand-ready obligation.

How we see it

Technology entities will need to evaluate whether unspecified upgrades and customer support are separate performance obligations, and whether the nature of the promise is to stand ready to provide the services to the customer. A time-based measure of progress recognized over the performance period may be appropriate for a performance obligation to provide unspecified upgrades.

An entity may account for the unspecified upgrades and customer support that is not part of the assurance warranty as a single performance obligation if it concludes that they have the same pattern of revenue recognition over the same period (e.g., both ratable over the contract term). This results in a revenue recognition pattern that is similar to the pattern required by legacy software guidance.

Specified upgrades

Technology entities may provide customers with the right to specified upgrades or enhancements as part of a software or SaaS contract. Under the standard, technology entities need to evaluate whether the rights to receive specified upgrades or enhancements are promised goods or services and separate performance obligations. If the specified upgrade is a separate performance obligation, a portion of the transaction price is allocated to it, and recognition of that amount of revenue is deferred until the specified upgrade is provided.

How we see it

Entities that license software are likely to recognize some revenue from contracts that involve specified upgrades earlier than they did under legacy guidance. Under the new standard, if the specified upgrade is determined to be a separate performance obligation, only the revenue allocated to that upgrade is deferred. Under legacy guidance, by contrast, entities that license software are often unable to separate the delivered elements from the specified upgrade because VSOE of fair value is generally unavailable for the specified upgrade.

Applying the new guidance may not significantly change revenue recognition for SaaS providers that have historically accounted for specified upgrades as separate deliverables by using the best estimate of selling price under the multiple-element arrangement guidance.

Unspecified additional software products

As part of a contract with a customer, a technology entity may license software and promise to deliver unspecified additional software products in the future. For example, the technology entity may agree to deliver all new products in a family of products over the next two years. Under the standard, technology entities must determine whether the promise to deliver unspecified additional software products is a separate performance obligation from the license. Technology entities also need to evaluate whether the promise to deliver unspecified additional software products is a stand-ready obligation to provide future products on a when-and-if-available basis or individual promises to deliver specified future products.

How we see it

This guidance changes how a technology entity accounts for unspecified future products and requires more analysis and judgment than legacy practice. Under legacy software guidance, unspecified additional software products are accounted for as subscriptions, and all revenue from the arrangement is recognized ratably over the term of the arrangement beginning with delivery of the first product.

Remix rights

A technology entity may provide a customer with the right to choose and change which mix of software licenses and/or SaaS products in its portfolio to use over the contract term (i.e., remix rights) in addition to PCS and unspecified additional software products. Some of these contracts, however, include limits, such as a cap on the number of users who can simultaneously use the products.

We believe these remix rights will typically be considered attributes of the related software licenses (or SaaS) and not separate promises since they do not create an obligation to transfer additional rights.

Entities must first evaluate whether the promises in the arrangement are separate performance obligations by evaluating whether each of the promises (e.g., each licensed software product, PCS, unspecified additional software products) is capable of being distinct and is distinct within the context of the contract.

Contracts with remix rights can take many forms (e.g., with terms that limit customer usage of the products or services included), and, if the entity determines that each of the promises is a separate performance obligation, allocating the transaction price to each of the performance obligations may require significant judgment and estimation.

Although the transaction price in arrangements with remix rights is allocated to each of the performance obligations on a relative standalone selling price basis, entities may be able to adjust the initial allocation to each performance obligation for expected customer usage (e.g., when they have reliable data about historical customer usage). Once the transaction price is allocated to the performance obligations, the allocation is not adjusted for subsequent changes to those estimates (e.g., for actual customer usage). Changes in the total transaction price generally are allocated to the separate performance obligations on the same basis as the initial allocation.

For example, the portfolio of products and services provided to a customer as part of a contract with remix rights may include access to a software product that is used by customers less frequently than the other products or services in the portfolio, based on historical customer usage data. In this fact pattern, the entity may conclude it is most appropriate to reflect in the initial allocation the expectation that fewer customers will use this software product than the other products or services in the portfolio.

Material rights

Under some contracts, a technology entity provides a customer with the option to purchase additional goods or services or renew a contract at a stated price. These options are separate performance obligations only if they provide a material right that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts the entity typically provides for those goods or services to that class of customer in that geographical area or market).

If an option is determined to be a separate performance obligation, a technology entity allocates a portion of the transaction price to the material right, based on its relative standalone selling price, and recognizes the allocated amount when it transfers those future goods or services or when the option expires. Evaluating whether an option provides a material right may be more complex when the standalone selling price of the good or service is highly variable, as illustrated below.

Illustration 2 — Evaluating a customer option when the standalone selling price is highly variable

Technology entity Y enters into a contract with Customer Z for a perpetual license of software A with one year of PCS. The contract also includes an option to purchase additional licenses of software A at 40% off list price.

The entity does not sell software A separately, but it sells PCS separately in the form of renewals that are consistently priced at 20% of the net license fee. Assume that Technology entity Y uses the residual method to estimate the standalone selling price of the perpetual license for software A. Also assume that the price Technology entity Y charges for the bundle of the perpetual license with PCS is highly variable. That is because the price Technology entity Y charges ranges from list price to a discount of up to 70% for the bundle to customers in the same class and same market as Customer Z who have not made prior purchases. (Assume that the entity has appropriately stratified its contracts/customers to evaluate the range of discounts and has a sufficient amount of transactions to support that this is the range of discounts it offers.)

Because the 40% discount Technology entity Y offered to Customer Z is within the range of discounts it typically offers to customers in the same class as Customer Z, Technology entity Y concludes that this option does not represent a material right.

The evaluation illustrated above is also applicable for SaaS contracts when a technology entity provides a customer with an option to purchase additional goods or services, and a similar approach may be taken for evaluating whether the option provides a material right in situations with highly variable pricing.

Volume discounts or tiered pricing can add an additional layer of complexity to the assessment of whether a customer option to purchase additional goods or services is a material right, as illustrated below.

The accounting for options to provide additional goods or services depends on whether the option provides a material right.

Illustration 3 — Evaluating a customer option with volume discounts

Semiconductor Entity S sells microchips for use in cell phones. The entity executes a contract with a customer to sell one million units of microchip M for $0.50 each, or $500,000. The contract provides the right for the customer to purchase an additional 200,000 microchips for $0.40 each, effectively bringing the price for all 1.2 million microchips to $0.48 per microchip.

The entity concludes that it has provided the customer with an option to purchase the additional microchips since the entity is not obligated to provide the additional goods until the customer makes a purchasing decision. Further, the volume discount is applied prospectively and does not affect the transaction price in the original contract.

Scenario A: For microchip M, Semiconductor Entity S provides volume discounts as part of its standard pricing practices and typically prices the first one million microchips at $0.50 each, the second million at $0.40 each and any additional amounts purchased at $0.35 each.

Semiconductor Entity S considers whether the option provides the customer with a material right. To make this evaluation, the entity compares the discount offered in this option with the discount typically offered to a similar high-volume customer that receives a discount independent of a prior contract. In other words, the entity compares the pricing in this contract to the pricing it typically offers to customers purchasing between one and two million units of microchip M without any prior purchases.

The entity has sold and continues to sell the same volume of microchip M at the same price to other customers in the same class of customer who have not made prior purchases (i.e., similar customers would pay $0.50 each for the first one million microchips and $0.40 each for the second million). That is, the price offered to the customer in the option exists independently of the existing contract. Therefore, Semiconductor Entity S concludes that it has not provided the customer with a material right.

Scenario B: For microchip M, Semiconductor Entity S provides volume discounts as part of its standard pricing practices and typically prices the first three million microchips at $0.50 each and any additional amounts purchased at $0.30 each.

Semiconductor Entity S considers whether the option provides the customer with a material right. To make this evaluation, the entity compares the discount offered in this option with the discount it typically offers to a similar high-volume customer that receives a discount independent of a prior contract.

For similar high-volume customers of the same customer class who have not made prior purchases, the entity typically does not provide this pricing (e.g., similar customers would pay $0.50 per microchip for all 1.2 million microchips). Therefore, the entity concludes that it has provided the customer with a material right.

Careful consideration should be given to whether the discount is offered to the customer independently of the existing contract.[18] If the customer is, in effect, paying the entity in advance for future goods or services, the option represents a material right.

An entity that concludes that an option is a separate performance obligation has to determine the standalone selling price of the option. As part of estimating the standalone selling price of an option, the entity should consider the additional discount that is provided by the material right (i.e., adjust for any discount that the customer could receive without exercising the option). Additionally, for goods or services that are both similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, ASC 606-10-55-45 provides an alternative to estimating the standalone selling price of an option (commonly referred to as the renewal option approach). See section 6.1.5 of our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*, for additional information on the renewal option approach.

How we see it

Significant judgment may be required to determine whether a customer option represents a material right. This determination is important because it affects the accounting and disclosures for the contract at inception and throughout the life of the contract.

While legacy software guidance also distinguishes between an option and a marketing offer, an entity may reach a different conclusion about whether an option represents a material right because the criteria in the new standard are not the same as those in legacy GAAP. That is, an option is no longer evaluated to determine whether it is significant and incremental to the range of discounts reflected in the pricing of the other elements in the contract. Instead, under the new standard, an entity evaluates whether an option provides the customer with a material right (e.g., a discount that exceeds the range of discounts the entity typically gives for those goods or services to a new customer in that class in that geographical area or market).

Applying the series guidance

Technology entities need to evaluate whether certain arrangements meet the criteria to be accounted for as a series of distinct goods and services. Entities should evaluate whether the distinct goods and services in a contract that represent separate performance obligations are substantially the same and have the same pattern of transfer (i.e., the performance obligation is satisfied over time using the same measure of progress). Goods and services that meet both criteria must be combined into one performance obligation and accounted for as a series of distinct goods or services. That is, accounting for goods or services as a series is required if the specified criteria are met.

The following examples were discussed by the TRG,[19] and we believe it is reasonable to conclude that the contracts in these examples should be accounted for under the series provision:

Illustration 4 — Example of IT outsourcing
A vendor and customer execute a 10-year IT outsourcing contract under which the vendor continuously provides server capacity, manages the customer's software portfolio, runs an IT help desk and provides other services. The monthly invoice is calculated based on customer usage for each of the services, which is measured differently for each service (e.g., based on millions of instructions per second of computer power used by the customer for the server capacity services). The vendor concludes that the customer simultaneously receives and consumes the benefits provided by its services as it performs (i.e., it meets the over-time criterion in ASC 606-10-25-27(a)).

The vendor first considers the nature of its promise to the customer. Because the vendor has promised to provide an unspecified volume of services rather than a defined amount of services, the TRG agenda paper noted that the vendor could reasonably conclude that the nature of the promise is to stand ready to provide the integrated outsourcing service each day.

If the nature of the promise is the overall IT outsourcing service, each day of service could be considered distinct because the customer can benefit from each day of service on its own and each day is distinct within the context of the contract. The TRG agenda paper also noted that the vendor could reasonably conclude that each day of service is substantially the same. That is, even if the individual activities that comprise the performance obligation vary from day to day, the nature of the overall promise is the same from day to day.

Illustration 5 — Example of transaction processing

A vendor enters into a 10-year contract with a customer to provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use the vendor's system, but the quantity of transactions the vendor will process is unknown. The vendor concludes that the customer simultaneously receives and consumes the benefits as it performs.

If the vendor concludes that the nature of its promise is to provide continuous access to its system rather than process a particular quantity of transactions, it might conclude that there is a single performance obligation to stand ready to process as many transactions as the customer requires. If that is the case, the TRG agenda paper noted that it would be reasonable to conclude that there are multiple distinct time increments of the service. Each day of access to the service provided to the customer could be considered substantially the same since the customer is deriving a consistent benefit from the access each day, even if a different number of transactions are processed each day.

If the vendor concludes that the nature of the promise is the processing of each transaction, the TRG agenda paper noted that each transaction processed could be considered substantially the same even if there are multiple types of transactions that generate different payments. Further, the TRG agenda paper noted that each transaction processed could be a distinct service because the customer could benefit from each transaction on its own and each transaction could be distinct within the context of the contract.

The series provision also may apply to SaaS contracts. For example, the customer may have access to various SaaS modules (e.g., revenue, inventory, procurement) in an entity's SaaS financial management application. If the entity concludes that the nature of the promise is to provide continuous access to its financial management application, each day of service is likely distinct and substantially the same. However, because SaaS contracts are usually sold with other goods and services (e.g., professional services), judgment may be required. The following illustrates how a technology entity might evaluate performance obligations in a SaaS contract:

Illustration 6 — Identifying performance obligations in a SaaS contract

SaaS provider A enters into a three-year contract with Customer X to provide access to its SaaS basic customer relationship management (CRM) and human resource management (HRM) applications (collectively referred to as SaaS applications) for $300,000. The contract also includes professional services that will personalize the user's interface based on the user's role. These services are sold separately from the SaaS applications and can be provided by third party vendors. The customer can benefit from the SaaS applications without the professional services, which do not significantly customize or modify the SaaS applications.

Entities that apply the series guidance may be required to allocate variable consideration to the period in which the related services were performed, if certain criteria are met.

SaaS provider A determines that the CRM and HRM applications and professional services are distinct (i.e., the CRM and HRM applications and the professional services should not be combined into a single performance obligation). The three services are each capable of being distinct because Customer X can benefit from each of the SaaS applications and professional services on its own. The services are distinct within the context of the contract because the services are not highly interdependent or interrelated and each service does not significantly modify or customize the other.

SaaS provider A first determines that the nature of the promise is providing continuous access to its CRM and HRM applications for the three-year period. Although the activities that Customer X may be able to perform via each of the SaaS applications may vary from day to day, the overall promise is to provide continuous access to the CRM and HRM applications to Customer X for a period of three years.

SaaS provider A determines that access to the CRM application represents a series of distinct services that are substantially the same and have the same pattern of transfer to Customer X. Each day of service is capable of being distinct because Customer X benefits each day from access to the CRM application. Each day is distinct within the context of the contract because there are no significant integration services, each day does not modify or customize another day and each day is not highly interdependent or interrelated. Each day of service is substantially the same because Customer X derives a consistent benefit from the access to the CRM application and has the same pattern of transfer over the term of the contract. Each distinct service represents a performance obligation that is satisfied over time and has the same measure of progress (e.g., time-elapsed). Therefore, the criteria to account for access to the CRM application as a series of distinct services (i.e., a single performance obligation) are met.

SaaS provider A performs a similar analysis for the access to the HRM application, determines that it also represents a series of distinct services and accounts for it as a single performance obligation. Like access to the CRM application, access to the HRM application is substantially the same, has the same pattern of transfer and therefore meets the criteria in the series guidance.

Access to the CRM and HRM applications is provided to Customer X concurrently over the term of the contract (i.e., coterminous), and the performance obligations have the same pattern of transfer. SaaS provider A may account for access to the SaaS applications as if they were a single performance obligation if the outcome is the same[20] as accounting for the goods and services as individual performance obligations.

SaaS provider A also considers whether the professional services meet the criteria to be accounted for as a series. As part of this assessment, the entity considers whether each day of the professional services is distinct from the other days or whether the nature of the promise for the professional services is for a combined output from all of the days. The entity also considers the complexity of the professional services and whether the activity of each day builds on one another or if each day is substantially the same. This analysis requires judgment and is based on the facts and circumstances of the professional services performed.

Allocating variable consideration under the series guidance

Variable consideration (e.g., a user-based fee) is allocated to one or more (but not all) performance obligations in the contract or one or more (but not all) distinct goods or services in a series of distinct goods or services if both criteria described in Step 4 in Appendix A are met (i.e., the variable consideration exception). This exception requires an entity to allocate variable consideration to the period that relates to its efforts to satisfy the performance obligation (e.g., a distinct month of services).

The FASB noted in the Basis for Conclusions of ASU 2014-09[21] that this exception is necessary because allocating contingent amounts to all performance obligations in a contract may not reflect the economics of a transaction in all cases. Allocating variable consideration entirely to a distinct good or service may be appropriate when the amount allocated to that particular good or service is reasonable relative to all other performance obligations and payment terms in the contract. Subsequent changes in variable consideration should be allocated in a manner that is consistent with the initial allocation.

For example, consider a SaaS contract for cloud storage in which a customer pays monthly fees based on the amount of storage space used during the month (e.g., a fixed contractual rate of $0.025 per gigabyte of storage is multiplied by the number of gigabytes used). Assume that the entity has appropriately concluded that the nature of the entity's performance obligation is to stand ready to provide any amount of storage space the customer needs at any time during the contract term, and the consideration in the contract is variable based on the number of gigabytes of storage used (and therefore each gigabyte used is not an optional purchase). The SaaS provided to the customer in this contract likely meets the criteria to be accounted for as a series of distinct goods or services. The entity would be required to allocate usage-based fees to each month if the entity determines that the payment relates specifically to the entity's efforts to satisfy the performance obligation for each month and that allocating the variable consideration to each distinct month is consistent with the allocation objective.

We believe that in order to meet the variable consideration exception criteria, the variable consideration should be consistent with the nature of the performance obligation. Consider a SaaS contract that provides access to a platform with multiple functionalities. The customer pays a usage-based fee of $0.05 per transaction based on the number of transactions processed through one of the platform's functionalities. The contract has an annual minimum guarantee of three million transactions. In effect, the customer pays a fixed fee of $150,000 and pays an overage fee of $0.05 per transaction for all transactions processed after the first three million. The entity determines that its performance obligation to provide access to the platform is a series of stand-ready obligations that are satisfied ratably over time.

In this example, the entity may conclude that it can't apply the variable consideration exception for the overage fees because this payment does not relate to the entity's efforts to satisfy the performance obligation to provide continuous access to the platform. That is, the nature of the performance obligation is a series of stand-ready obligations that are satisfied evenly over time, and the overage fees are additional consideration for satisfying that performance obligation.

The TRG discussed[19] the following examples of when an entity would conclude that a contract that is accounted for as a series of distinct goods or services meets the allocation objective and would allocate variable consideration to a distinct period of service such as day, month or year:

- An IT outsourcing contract in which the events that trigger the variable consideration are the same throughout the contract but the per-unit price declines over the life of the contract — The allocation objective could be met if the pricing is based on market terms (e.g., if the contract contains a benchmarking clause) or the changes in price are substantive and are linked to changes in the entity's cost to fulfill the obligation or the value provided to the customer.

- A contract to process an unknown quantity of transactions for a fixed contractual rate per transaction — The allocation objective could be met if the fees are priced consistently throughout the contract and the rates are consistent with the entity's standard prices for similar customers.

How we see it

Applying the variable consideration exception for a series of distinct services may result in a revenue recognition pattern that is similar to the accounting for contingent consideration under legacy guidance.

Additional considerations for technology contracts

The following section outlines some additional considerations for evaluating contracts with customers that may be relevant to technology contracts, including those that contain a software license.

Enforceable rights and obligations

Under the standard, a contract may be written, oral or implied by an entity's customary business practice, but it must create enforceable rights and obligations. Certain criteria also must be present in order for the arrangement to meet the definition of a contract within the scope of the standard.

A technology entity may enter into a master service agreement (MSA) with a customer that stipulates the terms and conditions (e.g., payment terms, use of service or content, confidentiality), but the contract may require separate purchase orders or order forms for specific goods and services to be exchanged for payment. In these cases, the purchase order generally creates enforceable rights and obligations and should be evaluated together with the MSA. That is, the purchase order commits the parties to perform their respective obligations, which is the transfer of promised goods and services in exchange for the specified consideration.

Determining the enforceable rights and obligations under a contract with termination rights may require significant judgment.

Termination clauses

Technology contracts may include clauses that allow a customer to terminate a contract without penalty, or the customer may be required to pay a termination penalty that is not substantive. The absence of a substantive termination penalty may affect an entity's determination of the length of the contract, the number of performance obligations, the transaction price, the timing of revenue recognition and the required disclosures.

The standard does not explicitly address the effect of termination penalties on the length of the contractual period. However, the TRG generally agreed[22] that a substantive termination penalty payable by a customer is evidence of enforceable rights and obligations on the part of both parties throughout the period when the substantive termination penalty applies.

The amount, nature and purpose of the termination penalty are factors to consider when determining whether the termination penalty is substantive. TRG members observed that the determination of whether a termination penalty is substantive, and what the enforceable rights and obligations are under a contract, requires judgment and consideration of the facts and circumstances. If the termination penalty is not substantive, the contract may be shorter than the stated contractual term. The following example demonstrates the effect of the termination penalty on the duration of a contract.

Illustration 7 — Determining the duration of the contract

SaaS provider A enters into a four-year SaaS contract with a customer. The customer is required to pay a nonrefundable annual fee of $100,000, which is the standalone selling price for the service.

To determine the duration of the contract in each of the scenarios below, the entity considers these facts and whether the contract provides cancellation rights and termination penalties.

Scenario A: Assume no cancellation rights are provided to either party. In this case, the enforceable rights and obligations exist for the entire stated contractual term, and the contract duration is four years.

Scenario B: Assume the contract provides the customer with a right to cancel the contract at the end of each year without cause but with a termination penalty. The penalty decreases annually throughout the contract term at the end of each year. The following illustrates the payments under the contract.

	Year 1	Year 2	Year 3	Year 4
Annual fee ($)	100,000	100,000	100,000	100,000
Termination penalty ($)	300,000	200,000	100,000	0

If SaaS provider A determines that the penalty is substantive in each period, enforceable rights and obligations exist for the stated contractual term of four years.

Scenario C: Assume the contract provides the customer with a right to cancel at the end of each year with no termination penalty. In this case, SaaS provider A determines that the contract duration is one year, with options to renew for each of the following three years because the customer can choose whether to receive the service during those years. That is, SaaS provider A determines that enforceable rights and obligations do not exist throughout the entire stated contractual term because there is no substantive termination penalty. The options to renew are not material rights because they are offered at the standalone selling price of $100,000.

Many professional services contracts such as a statement of work (SOW) have customer termination provisions with a minimum notification period (e.g., 30 days). For example, a SaaS vendor may sell a three-year SaaS solution and enter into an SOW to provide implementation services priced on a time and materials basis, which the SaaS vendor anticipates will take six months to complete. The SOW may provide the customer with the ability to terminate the SOW at any time with a 30-day notification period and only require the customer to pay for the services received (i.e., there is no substantive termination penalty). Such provisions need to be carefully evaluated because they will likely indicate that there are only enforceable rights and obligations in the contract for 30 days of professional services and that any additional days of service are optional purchases. Entities will need to evaluate whether the SOW contains an option to renew the implementation services and whether there are material rights in these situations.

How we see it

The evaluation of termination clauses is critical because the conclusions on the enforceable rights and obligations in a contract, including contract duration, can affect the determination and allocation of transaction price. Technology entities should closely evaluate the termination provisions in their contracts.

Contract modifications

Parties to a contract frequently agree to modify the scope or price (or both) of a contract. As illustrated in Example 5, Case B,[23] a contract modification may include compensation to a customer for performance issues (e.g., poor service by the entity, defects present in transferred goods). An entity may need to account for the compensation to the customer as a change in the transaction price separate from other modifications to the contract.

The standard requires certain modified contracts to be treated as entirely new contracts (either a second, separate contract or the termination of the existing contract and the creation of a new contract) and others to be treated as part of the original contract. The accounting treatment depends on whether the modification results in the addition of distinct goods or services and whether the amount of consideration expected for those goods or services reflects their standalone selling prices.

Consider a SaaS provider that enters into an agreement with a customer to increase the number of users with access to a SaaS subscription. Assume the services provided to the additional users are distinct. If the additional consideration reflects the standalone selling price of the additional service per user, the modification is accounted for as a separate contract. If the additional consideration does not reflect the standalone selling price, the modification is accounted for as the termination of the existing contract and the creation of a new contract. The revenue recognized to date on the original contract is not adjusted, and the remaining portion of the original contract and the modification are accounted for together by allocating the remaining consideration (i.e., the unrecognized transaction price from the existing contract plus the additional transaction price from the modification) to the remaining performance obligations. As part of this assessment, the SaaS provider also considers whether it has identified all the promises in the modified agreement.

If the modification involves a software license, we believe the additional and/or modified software license is likely distinct from the original license because the new and/or modified rights typically differ from those conveyed by the original license. Therefore, the accounting treatment depends on whether the additional consideration reflects the standalone selling price of the software license.

In determining the standalone selling price for evaluating the modification, entities have some flexibility to adjust the selling price depending on the facts and circumstances. For example, the SaaS provider in the example above may conclude that, when more users are added, the customer qualifies for lower pricing offered based on volume. While the per-user price for the additional users may be lower than the original per-user price, the SaaS provider may determine that the additional transaction consideration reflects the standalone selling price for the volume of users.

In situations with highly variable pricing, determining whether the additional consideration in a modified contract reflects the standalone selling price for the additional goods or services may not be straightforward. Entities will need to apply judgment when making this assessment. Evaluating whether the price in the modified contract is within a range of prices for which the good or service is typically sold to similar customers may be an acceptable approach.

How we see it

Technology entities have to evaluate whether to treat contract modifications as separate contracts or as modifications of existing contracts. This may be a change in practice for software or SaaS providers that currently treat agreements to add users as separate contracts. Under the new standard, treating a modification as a separate contract is permitted only if the consideration for providing distinct services to more users reflects the standalone selling price.

Collectibility

Technology entities may not expect to collect the full contract price for transferring goods or services when they enter into contracts with certain customers (i.e., customers in new or emerging markets). For a contract to be within the scope of the standard, it must be probable that the entity will collect substantially all of the consideration to which it expects to be entitled in exchange for the goods or services that will be transferred to the customer (i.e., the transaction price after considering variable consideration, including the constraint).

The amount of consideration that is assessed for collectibility is the amount to which the entity expects to be entitled, which under the standard is the transaction price for the goods or services that will be transferred to the customer rather than the price that is stated in the contract.

Differences between the transaction price and the contractual price most often relate to variable consideration (e.g., rebates, discounts, explicit or implicit price concessions) that reduces the amount of consideration stated in the contract. See the "Variable consideration" section for further discussion of implicit price concessions.

An entity also may consider its ability to manage its exposure to credit risk (e.g., through advance payments, through the right to stop transferring additional goods or services) as part of the collectibility assessment. Consider an IT service provider that enters into a three-year contract to provide data management services and has the right to stop providing services when the customer fails to pay. Based on its history with this class of customer, the IT service provider expects the customer to make the required payments for at least nine months. The IT service provider then evaluates whether it will collect substantially all of the consideration to which it will be entitled for the nine months of service.

When an entity determines that a contract with a customer does not meet the collectibility requirements of a contract under the standard, the entity should recognize nonrefundable consideration received as revenue only when one of the following events has occurred:[24]

- The entity has fully performed, and substantially all the consideration has been received (i.e., the entity has fully performed on all performance obligations in the contract and has received substantially all cash consideration for the entire contract).
- The contract has been terminated.
- The entity has transferred control of the goods or services and has stopped transferring (and has no obligation under the contract to transfer) additional goods or services to the customer, if applicable.

Technology entities need to carefully evaluate whether to recognize gross revenue or net revenue when third parties are involved in the sale of goods or services.

How we see it

Under the new standard, a technology entity needs to assess the customer's ability and intent to pay substantially all of the consideration to which the entity expects to be entitled. This amount may not be the contractual price.

It is no longer acceptable for entities to default to deferring revenue recognition until cash is collected if they have concerns about whether they will collect the contractual amount (i.e., they are unable to conclude that collectibility is reasonably assured).

Principal versus agent

A technology entity may publish advertising content from a third party on its website or mobile application. A technology entity also may provide a platform to sell virtual or digital goods on behalf of a third party. When another party is involved in providing goods or services to the technology entity's customer, the technology entity must determine whether its performance obligation is to provide the good or service itself (i.e., the technology entity is a principal) or to arrange for the other party to provide the good or service (i.e., the technology entity is an agent).

An entity is a principal if it controls a promised good or service before it transfers the good or service to a customer. The Board noted in the Basis for Conclusions of ASU 2016-08[25] that control is the determining factor in the assessment of whether an entity is a principal or an agent.

To apply the principal versus agent guidance, an entity must first properly identify the specified good or service (or unit of accounting for the principal versus agent evaluation) to be transferred to the customer. A specified good or service is defined as each distinct good or service or distinct bundle of goods or services promised to the customer. That is, the specified good or service is what the customer is ultimately purchasing, regardless of which entity is responsible for providing that good or service.

This assessment may be straightforward in transactions where a consumer product is being purchased from an online retailer, such as a song or a book (physical or intangible). The online retailer would often conclude that the consumer product is the specified good or service. The evaluation may be more complex when there are several goods or services purchased by the customer, particularly when the goods or services are sourced from different entities. For example, an entity may sell its hardware to customers, which may include software sourced from third parties. An entity would have to determine whether there are one or two specified goods or services in this transaction (i.e., hardware with embedded software or hardware and software separately) based on an evaluation of whether the separate promises are distinct from each other.

Determining whether an entity controls a good or service before it is transferred to the customer can be challenging if the good or service is intangible, such as digital content. As part of this evaluation, the standard requires the entity to consider the definition of control in ASC 606-10-25-25, which states that control is "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." An entity also should consider how the benefits from an asset can be obtained, including by selling or exchanging the asset. When evaluating control, an entity also should look to its contractual relationship with any third party involved in the contract to help the entity determine whether it has control of the good or service before that good or service is transferred to the customer.

Because it still may not be clear whether an entity controls the specified good or service, the standard provides three indicators (i.e., principal indicators) of when an entity controls the specified good or service (see Step 2 of the model in Appendix A). Generally, the inventory risk indicator won't apply to intangible goods or services, so technology entities need to consider the other indicators (i.e., responsibility for fulfilling the promise to provide the specified goods or service and discretion in establishing the price of the specified good or service) to determine whether they control intangible goods or services.

The FASB noted in the Basis for Conclusions of ASU 2016-08[26] that while the indicators can help to support an entity's assessment of control, they cannot replace the assessment. Further, the FASB explained that the indicators should not be viewed in isolation and are not a checklist of criteria that must be met in all cases. However, an entity's conclusions about control and the principal indicators should align. An entity that reaches different conclusions when it applies the standard's definition of control and when it considers the principal indicators should reevaluate its analysis, considering the facts and circumstances of the contract.

The illustration below, similar to Example 45[27] in the standard, demonstrates the control assessment for an entity that concludes that it is an agent:

Illustration 8 — Entity is an agent

An entity operates a website that provides a marketplace for customers to purchase goods from a variety of suppliers, who deliver the goods directly to the customers. The entity's website facilitates payment between the suppliers and the customers at prices that are set by the suppliers. The entity requires payment from customers before orders are processed, and all orders are nonrefundable. The entity has no further obligations to the customers after arranging for the products to be provided to the customers; the entity is not responsible for the acceptability of goods provided to customers.

First, the entity evaluates the specified goods and concludes that there are no other goods or services promised to the customer except those provided directly by the suppliers. Next, the entity considers whether it controls the specified goods before they are transferred to the customers. Since the entity does not at any time have the ability to direct the use of the goods transferred to the customers, the entity concludes that it does not control the specified goods before they are transferred. As part of this assessment, the entity also considers the three indicators of control in the standard and makes the following determinations that support its overall control evaluation:

- The suppliers are responsible for fulfilling the promise to the customer, and the entity does not take responsibility for the acceptability of the goods.
- The entity does not have inventory risk because it does not obtain the goods at any time.
- The entity does not have discretion in establishing prices because these are set by the suppliers.

The entity concludes that it is an agent for the goods sold through its website because the nature of its performance obligation is to arrange for goods to be provided to the customers.

By contrast, consider the following example of an entity that concludes it is acting as a principal:

Illustration 9 — Entity is a principal

An entity operates a website that provides a marketplace for customers to purchase digital content. The entity has entered into contracts with suppliers that provide the entity with the right to sell the digital content during a noncancelable period of time in exchange for a fixed fee per unit of content. The entity can set the price for the content to be sold to customers on its website. The entity is contractually required to pay the supplier a fixed price or rate for any digital content it sells to its customers that is unaffected by the price paid by the end customers. The entity is responsible for assisting customers if they encounter issues downloading the content or with the user experience, and customers do not interact with the suppliers.

The entity first evaluates the specified goods and concludes that the digital content is the only specified good or service. Next, the entity considers whether it controls the digital content before it is transferred to the customer. The entity concludes that it controls the specified goods before they are transferred because it has entered into a noncancelable distribution agreement that permits the entity to sell the digital content to its customers, which is different from the conclusion in Illustration 8 because that entity provided a platform to connect suppliers to customers and did not have the ability to sell the digital content. As part of this assessment, the entity also considers the three indicators of control in the standard and makes the following determinations that support its overall control evaluation:

- The entity is responsible for fulfilling the promise to the customer, and the entity takes responsibility for the acceptability of the goods.

- There is no inventory risk associated with digital content.
- The entity has discretion in establishing prices.

The entity concludes that it is a principal for the digital content sold through its website because it controls the content before it is transferred to the customer.

While these illustrations provide examples of the application of the control principle from the standard, entities need to evaluate the nature of their own transactions, including specific contractual terms, to determine whether they are agents or principals.

How we see it

While the new guidance on principal versus agent considerations is similar to legacy GAAP, the key difference is that the new guidance focuses on control of the specified goods and services as the overarching principle for entities to consider in determining whether they are acting as a principal or an agent. Entities must perform a robust assessment of control and should avoid focusing solely on the control indicators. This could result in entities reaching different conclusions from those they reached under legacy GAAP.

Variable consideration

Implied price concessions

Implied price concessions create variable consideration that must be estimated at contract inception.

Technology entities may be aware of potential collectibility issues at the outset of the contract but may still be willing to enter into the contract with a customer. When the entity is aware of such a risk and still chooses to transact with the customer, the contract may include an implied price concession. Under the standard, any implied price concessions create variable consideration, and an entity must estimate these amounts at contract inception.

Consider a technology entity that has a history of accepting consideration that is 60% of the contract price in a specific region in exchange for its software and PCS. When determining the transaction price for a contract in that region, the entity might determine that 60% of the contract price is the transaction price, and there is an implied price concession for the remaining 40% based on the entity's history.

Technology entities may find it challenging to distinguish between implied price concessions (i.e., reductions of revenue) and customer credit risk (i.e., bad debt) for collectibility issues that were known at contract inception. Entities need to carefully evaluate all facts and circumstances that were available at contract inception, as well as any subsequent events that may have affected the customer's ability to pay. Factors that technology entities may consider in determining whether the contract includes an implied price concession could be the customer's payment history and financial condition as well as market conditions in the region. Significant judgment is required when making this determination, and entities should retain contemporaneous documentation to support their judgments.

How we see it

Accounting for variable consideration resulting from implied price concessions significantly changes practice for technology entities that recognized revenue on a cash basis in these situations under legacy guidance. Under the new standard, a technology entity must estimate variable consideration in the transaction price, subject to the constraint (refer to Step 3 in of Appendix A), rather than default to deferring all revenue until the contingency is resolved. Entities are also required to update the estimated transaction price at each reporting date and potentially adjust revenue recognized.

Extended payment terms

Under the standard, an entity needs to consider whether any extended payment terms provided to the customer create variability in the transaction price (i.e., are a form of variable consideration) and whether a significant financing component exists.

An entity needs to carefully evaluate contracts that include extended payment terms to determine whether it has the intent or a reasonable expectation to provide a price concession. For example, a technology entity may routinely provide price concessions in contracts that include extended payment terms in order to negotiate contract renewals with customers. Entities are required to estimate the price concession at contract inception and reduce the transaction price for that amount.

How we see it

The treatment of extended payment terms under the new standard may accelerate the recognition of revenue for some technology entities. Under legacy guidance,[28] many entities that license software cannot overcome the presumption in ASC 985-605 that extended payment terms (i.e., payment terms greater than one year) result in a transaction price that is not fixed or determinable because there is an increased risk of the entity granting future price concessions to its customer. As a result, most technology entities have been unable to recognize revenue for contracts that include extended payment terms until the amounts are due because they are unable to demonstrate a history of successfully collecting without making concessions to the customer.

Reseller and distributor contracts

The standard likely changes practice for many technology entities that sell their products through distributors or resellers if the only uncertainty in the contract with the distributor or reseller is the variability in the transaction price (e.g., a semiconductor chip manufacturer may provide a distributor with volume discounts, rights of return and price protection rights). This is because the standard requires an entity to estimate the variable consideration (i.e., the end sales price) based on the information available, taking into consideration the effect of the constraint on variable consideration, and recognize revenue when control of the good or service is transferred to the reseller or distributor.

How we see it

Recognizing revenue (subject to the constraint on variable consideration) when products are delivered to a reseller is similar to the treatment under the "sell-in" method in legacy guidance. Entities can no longer apply the "sell-through" method and wait until the product is sold to the end customer to recognize revenue if the sales price is the only uncertainty in the contract with the distributor or reseller.

Variable consideration and options for additional goods and services

Technology entities need to exercise judgment to distinguish between contracts that contain an option to purchase additional goods or services (e.g., option to renew SaaS or PCS) and contracts that include variable consideration (e.g., rebates, credits, volume discounts). The TRG generally agreed[22] that entities should first determine the nature of the promises in the contract and the rights and obligations of the parties. Determining the nature of an entity's promise is critical to differentiating between optional purchases and variable consideration and may require significant judgment.

If the contract includes a customer option, the technology entity is not obligated to provide additional goods and services until the customer makes a separate purchasing decision (i.e., exercises the option). That is, the entity's performance obligation at contract inception is to provide the quantity of goods or services specified in the contract. Consider a contract with a customer to purchase a two-year subscription to a SaaS finance management application for 50 users for $100,000. The contract states that the customer can add additional users during the two-year period at a price of $800 per user per year, prorated for the precise period of access to the service. The entity determines that its performance obligation is to provide continuous access to the SaaS application for 50 users for the two-year term. The entity concludes that it has provided the customer with an option to purchase subscriptions for additional users because the entity is not obligated to provide access for the additional users until the customer makes a purchasing decision.

In contrast, if the entity is obligated to transfer the goods and services and the customer is obligated to pay for those promised goods and services, even if the consideration owed to the entity is not known at contract inception, the contract includes variable consideration. For example, consider a one-year contract for access to a SaaS application that allows the customer to process transactions, among other functions. The customer agrees to pay an annual fee of $100,000 plus overage fees at a rate of $0.1 per transaction based on the number of transactions processed through the application during the year that exceed one million (i.e., overage fees are only paid if the customer processes more than one million transactions during the year). Assume that the SaaS provider has determined that the nature of its performance obligation is to provide continuous access to the SaaS application regardless of the number of transactions processed. The SaaS provider determines that the $100,000 annual fee is fixed consideration and all additional consideration received as overage fees is variable consideration.

The determination of whether the contract contains a customer option or variable consideration is important because it affects the accounting for the contract at inception and throughout the life of the contract and the disclosures an entity has to make. Entities will need to make certain that their conclusions regarding the determination of the nature of the promise are consistent with conclusions regarding whether additional consideration that will be potentially received from the customer is related to variable consideration or optional purchases for additional distinct goods or services.

Technology contracts for products such as microprocessors, computer hardware or networking equipment may provide volume discounts or rebates that are based on the number of units sold.

The pricing adjustments provided by a volume discount or rebate determine whether it is accounted for as an option to purchase additional goods or services or variable consideration. Generally, a volume discount or rebate that is retrospectively applied is accounted for as variable consideration. This is because the final price of each good or service sold is dependent upon the customer's total purchases subject to the discount or rebate. That is, the consideration is contingent upon the occurrence or nonoccurrence of future events. This view is consistent with Example 24[29] in the standard.

Conversely, if a volume discount or rebate is prospectively applied (see Illustration 3 for an example), the discount or rebate may not be accounted for as variable consideration. This is because the consideration for the goods or services in the contract is not contingent on or affected by any future purchases. Rather, the discounts available from the rebate program affect the pricing on future purchases. However, technology entities need to evaluate whether the option to purchase goods or services in the future at a discount represents a material right and therefore should be accounted for as a performance obligation. If the entity determines that the option is a material right, the entity is required to allocate a portion of the transaction price to the material right at contract inception and recognize revenue when the option is exercised or the option expires.

Purchase or use additional copies of software

A technology entity may provide the customer with the option to purchase or use additional copies of software, and the customer may have the ability to replicate the software or download additional copies without further assistance from the technology entity. Questions have been raised about whether this type of option is an option to acquire additional software rights (i.e., an option for additional goods) or whether the extra copies represent additional usage of the software license (i.e., the additional usage gives rise to a sales- or usage-based royalty that likely meets the royalty recognition constraint).

The TRG generally agreed[30] that the entity has to exercise judgment to determine whether the contract is for a single license or for multiple licenses. In doing so, the entity considers whether the additional copies are distinct goods or services. Additional licenses are typically distinct because the customer can benefit from the additional license on its own and providing it does not modify, customize or have an interdependency with existing licenses. TRG members also generally agreed that while the customer may be able to replicate the software or download additional copies without the assistance of the technology entity, the entity may still be required to grant additional rights to the customer for the use of the additional copies of software.

An entity has provided a customer with an option if the customer can decide to purchase additional distinct copies of the software, and the entity is required to transfer those additional rights to the customer. Conversely, if the contract requires the customer to pay usage-based fees to compensate the vendor for the rights to use the software, these fees are treated as variable consideration. When the software license is the sole or predominant item to which the usage-based fees relate, the fees are accounted for as sales- and usage-based royalties rather than general variable consideration (see the "License contracts that include sales- or usage-based royalties" section above for further details).

How we see it

Significant judgment may be required to distinguish between a customer option and variable consideration, and identifying the nature of the entity's performance obligation will be critical to making the distinction. This determination is important because it will affect the accounting for the contract at inception and throughout the life of the contract.

Recognition of revenue

Measuring progress in a combined performance obligation

A single performance obligation may contain multiple goods or services that aren't distinct (i.e., a combined performance obligation). For example, hardware, software and professional services may be combined into a single performance obligation because the professional services significantly customize and integrate the hardware and software, and the hardware, software and professional services are inputs to a combined output.

The standard requires that a single method of measuring progress be used for each performance obligation satisfied over time. In the case of a combined performance obligation that is satisfied over time, the entity has to select a single measure of progress that most faithfully depicts the entity's performance in transferring the goods or services. Such a determination requires significant judgment, but TRG members generally agreed[31] that the measure of progress selected should be consistent with the standard's objective and that entities should consider the nature of the overall promise for the combined performance obligation. For example, the technology entity should not default to a "final deliverable" methodology or select a measure of progress that treats each promise as if it were a separate performance obligation.

In the example of the hardware, software and professional services that are combined into a single performance obligation (because one or more of the goods or services significantly modifies or customizes the other goods or services promised in the contract), the entity should consider a measure of progress that depicts the performance of the professional services. This is because the customer has not purchased each of the individual goods and services, but rather a customized solution for which each of the individual goods and services is an input (i.e., the entity concluded that the customizations are significant enough that the promises are not distinct within the context of the contract) and because the creation of the customized solution is performed over time (i.e., over the period during which the professional services are provided).

Similarly, an entity may conclude that a measure of progress that aligns with the SaaS may be appropriate for a hybrid-SaaS contract if the on-premise software and SaaS are a single performance obligation. This is because the entity has determined that it is providing a combined output over the period.

Contract costs

Costs to obtain a contract

Identifying costs to obtain a contract that are required to be capitalized

Entities may need to capitalize costs they would have expensed under legacy guidance.

The new guidance in ASC 340-40[32] requires entities to capitalize the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. An entity can expect to directly recover contract acquisition costs (i.e., receive reimbursement under the contract) or indirectly recover them (i.e., through the margin inherent in the contract). Incremental costs are costs an entity would not have incurred if the contract had not been obtained. Entities should first refer to the applicable liability standard to determine when they are required to accrue for certain costs. Entities would then use the guidance in ASC 340-40 to determine whether costs need to be capitalized.

For technology entities, the most common example of an incremental cost of obtaining a contract is a sales commission. Commissions paid to an account executive for signing a new customer or for the sale of additional goods or services (often called "land and expand") qualify as incremental costs of obtaining a contract if they are paid only as a result of signing the contract. Determining whether others types of commissions qualify for capitalization requires judgment. Commissions paid for renewals, commissions paid to supervisors and commissions not directly linked to any single or specific contract (e.g., commissions based on reaching an aggregate value of contracts booked during the year, meeting individual sales targets or accelerators) require careful consideration.

ASC 340-40 does not address considerations for different types of commission programs. However, the TRG indicated[33] that, to determine whether a cost is incremental and therefore capitalizable, an entity should consider whether it would still incur the cost if the customer (or entity) decided not to enter into the contract, just as parties were about to sign. If the costs would have been incurred even if the contract had not been executed, the costs are not incremental to obtaining that contract.

It is important to note that ASC 340-40 does not require costs to be direct in order to be capitalized. That's why the TRG members generally agreed[33] that an employee's title or level in the organization, or how directly involved the employee is in the sales process, should not affect the determination of whether a sales commission is incremental.

Entities also need to carefully evaluate all compensation plans, not just sales commission plans, to determine whether any plans contain incremental costs that should be capitalized. For example, "bonus" payments that are tied solely to obtaining contracts would be capitalized if they are incremental costs of obtaining a contract, regardless of the title of the plan or the title of the employee paid.

However, some entities pay compensation in increments or delay payments and require that an individual remain employed to collect a commission when it is due. In these circumstances, an entity needs to carefully evaluate whether the requirement to remain employed in order to receive the commission (i.e., the service vesting condition) is substantive (i.e., whether the time period is substantive).

The TRG indicated[34] that fringe benefits should also be capitalized as part of the incremental cost of obtaining a contract if the additional costs are based on the amount of commissions paid and the commissions qualify as costs to obtain a contract. However, if the costs of fringe benefits would have been incurred regardless of whether the contract had been obtained (e.g., health insurance premiums), the fringe benefits should not be capitalized. That is, an entity cannot allocate to the commission and, therefore, capitalize a portion of the costs of benefits it would provide regardless of whether the commission was paid.

When evaluating the period over which a sales commission should be amortized, entities should assess whether the amortization period for a sales commission extends beyond the initial contract period because the capitalized costs relate to goods or services that are transferred under multiple contracts or to a specific anticipated contract (e.g., certain contract renewals). For example, the expected period of benefit of the sales commission could extend beyond the first contract, such as when the entity expects the customer to renew PCS or SaaS.

Amortization of capitalized costs to obtain a contract

When determining whether the amortization period for a sales commission extends beyond the contract period, an entity should also evaluate whether an additional commission is paid for subsequent renewals. In the Basis for Conclusions of ASU 2014-09,[35] the FASB explained that amortizing the asset over a longer period than the initial contract would not be appropriate if an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. In that case, the costs of obtaining the initial contract do not relate to the subsequent contract. Judgment is required to determine whether a renewal commission is commensurate with the commission paid on the initial contract. For example, a 6% commission on an initial contract and a 2% commission on a renewal would not be commensurate even if the declining commission rate corresponds to the level of effort required to obtain the contracts. Further, before including estimated renewals in the period of benefit, the entity should evaluate its history with renewals to conclude that such an estimate is supportable.

The TRG generally agreed[33] that ASC 340-40 does not require an entity to amortize the asset over the average customer life. Instead, TRG members said entities would make similar judgments to those used to estimate the amortization period for intangible assets (e.g., a customer relationship intangible acquired in a business combination) and could consider factors such as customer "stickiness" and how quickly their products and services change. Capitalized costs should be amortized over a period that is consistent with the transfer to the customer of the goods or services to which the asset relates.

Consider a technology entity that capitalizes a commission earned on the sale of software, which the entity estimates it will maintain and support for only the next five years, and the estimated customer life is seven years. In evaluating the period of benefit, the entity may reasonably conclude the capitalized commission should be amortized over the five-year life of the software to which the commission relates. Entities may need to apply judgment when determining the amortization period.

Allocating capitalized costs to obtain a contract to individual performance obligations

An entity can attribute the capitalized contract costs to the individual performance obligations in the contract to determine the appropriate amortization period, but it is not required to do so by the standard. An entity may meet the amortization objective in ASC 340-40-35-1 by allocating the capitalized costs to performance obligations on a relative basis (i.e., in proportion to the transaction price allocated to each performance obligation) to determine the period of amortization.

For example, an entity executes a contract for $600,000 for a perpetual software license and one year of PCS. Based on the standalone selling prices, the entity allocates $500,000 (83%) of the total transaction price to the license and $100,000 (17%) to the PCS. The entity pays a 4% commission to the sales representative and has determined that the commission is required to be capitalized under ASC 340-40 because it is an incremental cost of obtaining the contract. The entity concludes that the $24,000 sales commission should be allocated between the license and the PCS and amortized over the expected period of benefit associated with each of those performance obligations. The entity allocates $20,000 (83%) to the license and $4,000 (17%) to the PCS, consistent with the relative value of the performance obligations to the transaction price.

Other methods for allocating capitalized costs may be appropriate. Entities should consistently apply any methods used for allocating capitalized costs to performance obligations.

Impairment of capitalized costs to obtain a contract

Because costs that give rise to an asset must continue to be recoverable throughout the contract period (or period of benefit, if longer) to meet the criteria for capitalization, any asset recorded by the entity is subject to an impairment assessment at the end of each reporting period based on the hierarchy described in ASC 340-40-35-5. Entities that record capitalized costs on a contract-by-contract basis will have to monitor and record impairment as customers terminate or allow services to lapse (i.e., in line with customer attrition). Therefore, entities may find a portfolio approach easier to operationalize than accounting for contract costs individually.

How we see it

Technology entities may capitalize more types of commission costs under the new standard than they did under legacy guidance.

Entities planning to use the full retrospective transition approach need to calculate the effect of the new accounting guidance for costs to obtain a contract on the financial statements for all periods presented. This may require entities to understand changes in compensation plans and to obtain data from prior years that may not have been subject to effective internal controls, including controls over the IT systems that generated the data.

Costs to fulfill a contract

Technology entities incur costs to fulfill a contract, such as when they install semiconductor processing equipment or implement SaaS for a customer. These entities need to first determine whether the installation or implementation activity is eligible for capitalization under other US GAAP (e.g., property, plant and equipment; intangibles). If it is not eligible for capitalization under other US GAAP, technology entities need to determine whether the installation or implementation service meets the definition of a separate performance obligation and, if it does, expense the costs associated with that performance obligation as incurred.

If the installation or implementation is not a separate performance obligation (see discussion in the "Implementation services" section above), a technology entity needs to evaluate whether it is required to capitalize the costs to fulfill the contract. Costs incurred to fulfill a contract are required to be capitalized only if those costs meet all of the following criteria:

- The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (e.g., costs relating to services to be provided under renewal of an existing contract, costs of designing an asset to be transferred under a specific contract that has not yet been approved).
- The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- The costs are expected to be recovered.

The standard requires entities to expense costs that relate to satisfied (or partially satisfied) performance obligations in the contract when they are incurred. Once an entity has begun satisfying a performance obligation that is satisfied over time, it should only capitalize costs that relate to future performance. If an entity is unable to determine whether certain costs relate to past or future performance, and the costs are not eligible for capitalization under other US GAAP guidance, the costs are expensed as incurred.

In addition to direct labor and material costs, examples of costs the standard requires to be capitalized if certain criteria are met include management and supervision, insurance and depreciation of the tools and equipment used to fulfill the contract. Technology entities therefore have to exercise significant judgment to identify all the costs that should be capitalized.

How we see it

A technology entity may incur costs that are required to be capitalized when it performs implementation services for SaaS or software that are not distinct or when it performs IT outsourcing services. Determining whether the costs associated with implementation services for SaaS or software are required to be capitalized may require judgment.

A technology entity first must determine whether the implementation services are a separate performance obligation. If these services are determined to be a separate performance obligation, the related costs are expensed as incurred.

If a technology entity determines that implementation services are not a separate performance obligation, it needs to evaluate whether the related costs meet the three criteria in the standard to be capitalized. As part of this assessment, an entity needs to evaluate whether the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, including whether the implementation services are required in order for the customer to use the SaaS or software, which may be challenging.

Disclosure requirements

The standard significantly increases the volume of interim and annual disclosures. For public entities, these disclosures include disaggregated revenues, qualitative and quantitative information about contracts with customers and significant judgments made in applying the standard and costs to obtain or fulfill a contract. Nonpublic entities can choose to provide the same or streamlined disclosures.

Some of the specific disclosure requirements that may affect technology entities include:

- Entities must evaluate how to disaggregate revenue (e.g., by product or service, geographical region) to meet the disaggregation objective. Entities also have to reconcile any differences between this disclosure and segment disclosures. When determining the categories to use to disaggregate revenue, entities should consider how information about revenue has been presented for other purposes, including disclosures presented outside the financial statements and information reviewed by the chief operating decision maker for evaluating the performance operating segments.

- Entities must disclose the aggregate amount of the transaction price that is allocated to performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period. For example, if an entity estimates a total transaction price of $5 million for a contract and has recognized $3 million to date, it discloses that $2 million of the transaction price is yet to be recognized, along with either quantitative or qualitative information on when the remaining transaction price is expected to be recognized.

Entities can elect to use an optional exemption that allows an entity not to make quantitative disclosures about remaining performance obligations in certain situations, including when contracts have an original expected duration of less than one year and when an estimate of the transaction price is made solely for disclosure purposes. These situations also include: (1) when an entity applies the "right to invoice" practical expedient in ASC 606-10-55-18, (2) when an entity recognizes revenue for licenses of IP following the sales- and usage-based royalty recognition constraint and (3) when variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation (i.e., a series of distinct goods or services) when certain criteria are met.

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

How we see it

Preparing the required interim and annual disclosures may require significant effort. Entities need to make sure that they have appropriate policies and procedures, systems and internal controls in place to collect and disclose the required information.

Endnotes:

1 Under US GAAP, public entities, as defined, will be required to adopt the standard for annual reporting periods beginning after 15 December 2017 (1 January 2018, for calendar-year public entities), and interim periods therein. Nonpublic entities will be required to adopt the standard for annual reporting periods beginning after 15 December 2018, and interim periods within annual reporting periods beginning after 15 December 2019. Public and nonpublic entities can adopt the standard as early as the original public entity effective date (i.e., annual reporting periods beginning after 15 December 2016, and interim periods therein). Early adoption prior to that date is not permitted.

2 Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, as amended, and created by Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*.

3 The FASB and the International Accounting Standards Board (IASB) created the TRG to help them determine whether more guidance is needed on their new revenue standards (ASC 606 and the IASB's standard, IFRS 15 *Revenue from Contracts with Customers*) and to educate constituents. While the group met jointly in 2014 and 2015, only FASB TRG members participated in meetings in 2016.

4 The AICPA formed 16 industry task forces to help develop a new accounting guide on revenue recognition and to aid industry stakeholders in implementing the standard.

[5] ASC 985-20-15-5.

[6] Paragraph BC37 of ASU 2016-10, *Identifying Performance Obligations and Licensing*.

[7] ASC 606-10-55-141 through 55-145.

[8] Although the standard does not describe this evaluation in detail, it indicates that the technical support and updates are capable of being distinct. While the technical support and updates do not provide any benefit to the customer without the software license, they are capable of being distinct because they can each provide benefit to the customer together with the software license, which is considered a readily available resource. The software license is considered readily available given that it is a resource that is already transferred to the customer under the contract.

[9] ASC 606-10-55-140D through 55-140F.

[10] Paragraph BC71 of ASU 2016-10.

[11] Speech by Wesley R. Bricker, 9 June 2016. Refer to SEC website at https://www.sec.gov/news/speech/bricker-remarks-35th-financial-reporting-institute-conference.html.

[12] ASC 606-10-32-36 through 32-38.

[13] ASC 606-10-32-39 through 32-41.

[14] Paragraph BC271 of ASU 2014-09.

[15] ASC 606-10-32-34(c).

[16] 26 January 2015 TRG meeting; agenda paper no. 16.

[17] 26 January 2015 TRG meeting; agenda paper no. 25.

[18] 18 April 2016 TRG meeting; agenda paper no. 54.

[19] 13 July 2015 TRG meeting; agenda paper no. 39.

[20] Paragraph BC116 of ASU 2014-09.

[21] Paragraph BC284 of ASU 2014-09.

[22] 9 November 2015 TRG meeting; agenda paper no. 48.

[23] ASC 606-10-55-114 through 55-116.

[24] This accounting treatment is also achieved when an arrangement does not meet any of the other criteria in ASC 606-10-25-1 to be accounted for as a contract with a customer.

[25] Paragraph BC31 of ASU 2016-08, *Principal versus Agent Considerations*.

[26] Paragraph BC16 of ASU 2016-08.

[27] ASC 606-10-55-317 through 55-319.

[28] SEC Staff Accounting Bulletin Topic 13 notes entities should consider the guidance on extended payment terms in ASC 985-605 even if the arrangement is not subject to the scope of that standard.

[29] ASC 606-10-55-216 through 55-220.

[30] 9 November 2015 TRG meeting; agenda paper no. 45.

[31] 13 July 2015 TRG meeting; agenda paper no. 41.

[32] ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*, was created by ASU 2014-09.

[33] 7 November 2016 TRG meeting; agenda paper no. 57.

[34] 26 January 2015 TRG meeting; agenda paper no. 23.

[35] Paragraph BC309 of ASU 2014-09.

Appendix A: The five-step revenue model and contract costs

The standard's core principle is that an entity recognizes revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. That principle is applied using five steps that will require entities to exercise judgment when considering the terms of their contract(s) and all relevant facts and circumstances. Entities have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. This table summarizes the new revenue model and the guidance for contract costs.

Step 1: Identify the contract(s) with the customer

Definition of a contract

An entity must first identify the contract, or contracts, to provide goods and services to customers. A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices but must meet the following criteria:

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

If these criteria are not met, an entity would not account for the arrangement using the model in the standard and would recognize any nonrefundable consideration received as revenue only when certain events have occurred.

Contract combination

The standard requires entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if they meet any of the following criteria:

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

Contract modifications

A contract modification is a change in the scope and/or price of a contract. A contract modification is accounted for as a new contract separate from the original contract if the modification adds distinct goods or services at a price that reflects the standalone selling prices of those goods or services. Contract modifications that are not accounted for as separate contracts are considered changes to the original contract and are accounted for as follows:

- If the goods and services to be transferred after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract
- If the goods and services to be transferred after the contract modification are not distinct from the goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract
- A combination of the two approaches above: a modification of the existing contract for the partially satisfied performance obligations and the creation of a new contract for the distinct goods and services

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

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

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

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

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

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

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

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

Series guidance

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

Customer options for additional goods or services

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

Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls a promised good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services. Because it is not always clear whether an entity controls a specified good or service in some contracts (e.g., those involving intangible goods and/or services), the standard also provides indicators of when an entity may control the specified good or service as follows:

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

Step 3: Determine the transaction price

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

Variable consideration

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

Significant financing component

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

Noncash consideration

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

Consideration paid or payable to the customer

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

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

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

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

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

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

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

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

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

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

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

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

Licenses of intellectual property
The standard provides guidance on the recognition of revenue for licenses of intellectual property (IP) that differs from the model for other promised goods and services. The nature of the promise in granting a license of IP to a customer is either: ▸ A right to access the entity's IP throughout the license period (a right to access) ▸ A right to use the entity's IP as it exists at the point in time in which the license is granted (a right to use) To determine whether the entity's promise is to provide a right to access its IP or a right to use its IP, the entity should consider the nature of the IP to which the customer will have rights. The standard requires entities to classify IP in one of two categories: ▸ Functional: This IP has significant standalone functionality (e.g., many types of software, completed media content such as films, television shows and music). Licenses of functional IP generally grant a right to use the entity's IP, and revenue for these licenses generally is recognized at the point in time when the IP is made available for the customer's use and benefit. This is the case if the functionality is not expected to change substantially as a result of the licensor's ongoing activities that do not transfer an additional promised good or service to the customer. If the functionality of the IP is expected to substantively change because of activities of the licensor that do not transfer additional promised goods or services, and the customer is contractually or practically required to use the latest version of the IP, revenue for the license is recognized over time. ▸ Symbolic: This IP does not have significant standalone functionality (e.g., brands, team and trade names, character images). The utility (i.e., the ability to provide benefit or value) of symbolic IP is largely derived from the licensor's ongoing or past activities (e.g., activities that support the value of character images). Licenses of symbolic IP grant a right to access an entity's IP, and revenue from these licenses is recognized over time as the performance obligation is satisfied (e.g., over the license period). Revenue cannot be recognized from a license of IP before both (1) an entity provides (or otherwise makes available) a copy of the IP to the customer and (2) the beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the IP. The standard specifies that sales and usage-based royalties on licenses of IP are recognized when the later of the following events occurs: (1) the subsequent sales or usage occurs or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). This guidance must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP (i.e., these types of arrangements are either entirely in the scope of this guidance or entirely in the scope of the general variable consideration constraint guidance).
Contract costs
ASC 340-40 specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers. The incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. The standard provides a practical expedient that permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. An entity accounts for costs incurred to fulfill a contract with a customer that are within the scope of other authoritative guidance (e.g., inventory, property, plant and equipment, internal-use software) in accordance with that guidance. If the costs are not in the scope of other accounting guidance, an entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria: ▸ The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify. ▸ The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future. ▸ The costs are expected to be recovered. Any capitalized contract costs are amortized, with the expense recognized as an entity transfers the related goods or services to the customer. Any asset recorded by the entity is subject to an impairment assessment at the end of each reporting period.

Appendix B: Additional topics

Technology entities also may need to consider the following topics. The sections listed below refer to sections in our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*.

- Significant financing component — section 5.5
- Noncash consideration — section 5.6
- Consideration paid or payable to a customer — section 5.7
- Customer acceptance — section 7.2.1
- Warranties — section 9.1