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Technical Line

FASB — final guidance

The new revenue recognition standard — software and cloud services

In this issue:

What you need to know

- The new standard is more principles-based than current guidance and will require software entities to exercise more judgment. Software entities, including those that sell products through resellers or distributors, may recognize some revenue sooner than they do today.
- Entities will no longer be required to establish vendor-specific objective evidence of fair value to account for goods and service separately.
- Entities will need to evaluate whether services that are now considered post-contract customer support and often treated as a single unit of accounting will be separate performance obligations.
- Entities will be required to capitalize incremental costs of obtaining a contract (e.g., sales commissions) that meet certain criteria. This may change practice for entities that currently expense such costs.
- The standard is effective for public entities for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities for fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018.

Overview

Software entities likely will need to change certain revenue recognition practices as a result of the new revenue recognition standard jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards). The

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new revenue recognition standard will supersede virtually all revenue recognition guidance in US GAAP and IFRS, including industry-specific guidance that software entities use today.

The new standard provides accounting guidance for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP requirements, such as the leasing literature). The guidance also provides a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate.

The new standard is less prescriptive than today's revenue guidance for software arrangements in Accounting Standard Codification (ASC) 985-605[1] and will require software entities to use more judgment than they do today. For example, in one of the most significant changes, vendor-specific objective evidence (VSOE) of fair value is not required in order to account for elements in an arrangement as separate units of accounting. As a result, many entities will likely reach different conclusions than they do today about which goods and services can be accounted for separately and the amounts allocated to them.

The new standard also could change practice for software entities that sell their products through distributors or resellers. Today, many entities don't recognize revenue until the product is sold to the end customer because they do not meet all of the revenue recognition criteria in ASC 985-605 or Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) Topic 13.[2] Under the new standard, based on the facts and circumstances of an arrangement, software entities could reach different conclusions than they do today and recognize revenue earlier because they will be required to estimate variable consideration and include such amounts in the transaction price, subject to a constraint. Applying the constraint on variable consideration introduces a different threshold for measurement and recognition than SAB Topic 13.

The SEC staff hasn't said whether it will change or rescind SAB Topic 13 which applies to all public entities and is widely followed by other entities. Among other things, it requires that revenue be fixed or determinable to be recognized.

The requirement to capitalize the incremental costs of obtaining a contract (e.g., sales commissions) and recognize them as assets if the entity expects to recover them also will be a significant change for entities that have historically expensed such costs. Practice is divided today. Some software companies already capitalize these costs by analogizing to guidance that is narrow in scope.

This publication discusses how the new revenue standard will affect entities that currently apply the software guidance in ASC 985-605. It provides an overview of the revenue recognition model and highlights key considerations for the software industry. This publication supplements our Technical Line, *A closer look at the new revenue recognition standard* (SCORE No. BB2771), and should be read in conjunction with it. For a discussion of the key considerations for technology entities that do not currently apply software guidance, refer to our Technical Line, *The new revenue recognition standard — technology* (SCORE No. BB2804).

Software entities also may want to monitor the discussions of both the Boards' Joint Transition Resource Group for Revenue Recognition (TRG) and a task force formed by the American Institute of Certified Public Accountants (AICPA) to focus on software issues. The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG won't make formal recommendations to the Boards or issue guidance. The AICPA's software industry task force is one of 16 industry task forces the

AICPA has formed to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance produced by the AICPA is non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will update our guidance.

Scope, transition and effective date

The scope of the new revenue recognition guidance includes all contracts with customers to provide goods or services in the ordinary course of business, except for contracts that are specifically excluded (e.g., leases, insurance contracts, financial instruments, guarantees). Also excluded from the scope of the guidance are nonmonetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange.

The standard is effective for public entities[3] for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities in fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018, and they may elect to adopt the guidance as early as the public entity effective date. Under US GAAP, early adoption is prohibited for public entities.

Software entities will need to exercise more judgment.

All entities will be required to apply the standard retrospectively, either using a "full retrospective" or a "modified retrospective" approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

Under the modified retrospective approach, financial statements will be prepared for the year of adoption using the new standard, but prior periods won't be adjusted. Instead, an entity will recognize a cumulative catch-up adjustment to the opening balance of retained earnings (or other appropriate component of equity or net assets) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). Entities will need to provide certain disclosures in the year of adoption, such as the amount by which each financial statement line item is affected as a result of applying the new standard.

Summary of the new model

The new guidance outlines the principles an entity must apply to measure and recognize revenue and the related cash flows. The core principle is that an entity will recognize 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.

The principles in the new standard will be applied using the following five steps:

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

Software entities will need to exercise judgment when considering the terms of the contract(s) and all of its facts and circumstances, including implied contract terms. An entity also will have to apply the requirements of the new standard consistently to contracts with similar characteristics and in similar circumstances.

On both an interim and annual basis, an entity will have to make more disclosures than it does today and include qualitative and quantitative information about its contracts with customers, significant judgments made (and changes in those judgments) and contract assets from costs to obtain or fulfill a contract. On an interim basis, US GAAP will require more disclosure than will be required under IFRS.

Identify the contract(s) with a customer

Contracts may be written, oral or implied by an entity's customary business practices but must be enforceable by law, which the Boards acknowledged may differ by jurisdiction. Further, the Boards identified certain criteria that must be present in order for an arrangement to meet the definition of a contract within the scope of the new standard. These criteria include approval of the contract by all parties, identification of each party's rights regarding goods and services to be transferred and the associated payment terms, and determination that the contract has commercial substance. In addition, an entity must conclude that it is probable that it will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. These criteria are assessed at the inception of the arrangement and, if met, are not reassessed unless there is a significant change in facts and circumstances.

Under today's software guidance, entities are restricted from recognizing revenue from a licensing arrangement until persuasive evidence of the arrangement exists, even if the software has been delivered and the other general revenue recognition criteria have been met. The guidance says that, if an entity has a customary business practice of using written contracts, persuasive evidence of an arrangement does not exist until a final agreement has been executed by both the customer and the entity, demonstrating that the parties agree on the terms and conditions of the arrangement.

Under the new standard, entities will likely need to exercise judgment to determine whether a contract creates enforceable rights and obligations. For example, a customer may sign and return a contract that the entity has not yet signed, or the entity may deliver a software license to the customer before both parties sign the contract. In these cases, the analysis today would be relatively straightforward, and the entity would not be able to conclude that persuasive evidence of the arrangement exists. Under the new standard, an entity may or may not reach a similar conclusion. Entities will have to exercise more judgment to determine whether enforceable rights and obligations have been created between the parties in the arrangement.

How we see it

The standard could change practice for software entities. A software entity may determine that enforceable rights and obligations exist as soon as performance begins, rather than when the contract is signed by both parties. However, careful consideration of the facts and circumstances of an arrangement will be required to determine when enforceable rights and obligations exist. This evaluation will be affected by laws and legal precedents involving enforceability in the customer's jurisdiction and will require significant judgment. Software entities will need robust documentation to demonstrate that a contract is enforceable by law. Software entities may need to develop or update processes to reflect the change in the accounting guidance.

When considering collectibility, an entity will consider the customer's ability and intent to pay the consideration when due. This criterion creates a collectibility threshold similar to the current collectibility requirement in SAB Topic 13 and ASC 985-605, with one significant difference. The Boards acknowledged that an entity may enter into an arrangement not expecting to collect the full contract amount (e.g., the contract contains an implied price concession) and, therefore, the entity needs to assess collectibility of the amount to which it expects to be entitled, rather than the stated contractual amount. This difference could result in the earlier recognition of revenue for arrangements in which a portion of the contract price is considered to be at risk, but not the entire amount. Refer to the section below on determining the transaction price.

Illustration 1: Collectibility is probable

Software Co. decides to enter a new region that is currently experiencing economic difficulty. Software Co. expects the economy to recover over the next two to three years and determines that building a relationship in the current environment could result in potential growth in future years. Software Co. enters into an arrangement with a customer in the new region for a software license for promised consideration of $1 million. At contract inception, Software Co. expects that it may not be able to collect the full amount from the customer.

Assuming the contract meets the other criteria to be within the scope of the new revenue standard, Software Co. assesses whether collectibility is probable. In making this assessment, Software Co. considers whether the customer has the ability and intent to pay the estimated transaction price, which may be an amount less than the contract price (e.g., the entity may offer a price concession to the customer). For purposes of this example, assume Software Co. determined at contract inception that it may be forced to grant the customer a price concession, and it was willing to do so up to $200,000, if necessary. As a result, Software Co. determined that the amount to which it is entitled is $800,000 and performs the collectibility assessment based on that amount rather than the $1 million contract price.

Refer to our discussion of implied price concessions in the variable consideration section,

How we see it

Software entities may struggle with applying the collectibility criterion. Under today's guidance, when software entities have significant concerns about whether they will collect the stated contractual amount (i.e., they are unable to conclude collectibility is reasonably assured), they defer the recognition of revenue until cash is collected. Under the new revenue standard, software entities will need to carefully evaluate and make a judgment about the customer's ability and intent to pay the amount to which they expect to be entitled, which won't necessarily be the contractual price. As a result, entities may reach different conclusions than they do today and may recognize revenue earlier.

Contract modifications

A contract is modified when there is a change in the scope or price (or both). Changes to existing contracts, such as extensions or renewals of software licenses, are examples of contract modifications that may occur in software arrangements.

An entity must determine whether the modification should be accounted for as a separate contract or as part of the existing contract. Two criteria must be met for a modification to be treated as a separate contract: (1) the additional goods and services are distinct from the goods and services in the original arrangement and (2) the amount of consideration expected for the added goods and services reflects the standalone selling price of those goods or services. In this respect, only modifications that *add* distinct goods and services to the arrangement can be treated as separate contracts. In determining the standalone selling price, entities have some flexibility, depending on the facts and circumstances. For example, an entity may conclude that, with additional purchases, a customer qualifies for a volume-based discount.

A contract modification that does not meet the criteria to be accounted for as a separate contract is considered a change to the original contract and is treated as either the termination of the original contract and the creation of a new contract, or as a continuation of the original contract depending on whether the remaining goods or services to be provided after the contract modification are distinct. A modification is accounted for on a prospective basis (i.e., as a termination of the original contract and creation of a new contract), if the goods and services subject to the modification are distinct from the other goods and services provided within the original contract but the consideration does not reflect the standalone selling price of those goods or services. An entity should account for a modification as a continuation of the original contract if the goods or services added or removed are not distinct from the goods and services already provided. Such modifications are accounted for on a cumulative catch-up basis.

Illustration 2: Contract modification is not a separate contract

Software Co. enters into an arrangement with a customer to significantly customize a financial reporting application for $30,000. Based on its experience, Software Co. determines that customizing the application will take two technicians approximately 150 hours at a rate of $200 per hour (i.e., $30,000) to complete the project. Assume Software Co. accounts for the services as a single performance obligation and satisfies the performance obligation over time because the customer simultaneously receives and consumes the benefits provided as Software Co. performs.

After incurring 30 hours of time (satisfying 20% of the performance obligation), Software Co. and the customer agree to change an aspect of the project that increases the estimate of labor hours by 50 hours at a rate of $100 per hour. The contract is modified to reflect a total price of $35,000 for a total of 200 hours.

Software Co. accounts for the contract modification as part of the original contract because the service is not distinct and, therefore, is part of the single performance obligation that is partially satisfied at the date of the contract modification. Software Co. updates its measure of progress and estimates that it has satisfied 15% of its performance obligation (30 hours incurred at contract modification ÷ 200 hours total expected to complete the project). Software Co. recognizes a reduction in revenue of $750 [$6,000 revenue recognized to date — (15% complete × $35,000 modified transaction price)] at the date of the modification as a cumulative catch-up adjustment.

Identify the performance obligations in the contract

Software arrangements commonly involve the delivery of multiple goods and services, such as a software license, unspecified or specified future upgrades and enhancements, maintenance and other professional services. Goods or services promised in a contract with a customer can be either explicitly stated in the contract or implied by an entity's customary business practice. The new standard requires entities to consider whether the customer has a valid expectation that the entity will provide a good or service when it is not explicitly stated. If the customer has a valid expectation, the customer would view those promises as part of the goods or services in the contract.

Promised goods and services represent separate performance obligations if the goods or services are distinct (by themselves or as part of a bundle of goods and services) or if the goods and services are part of a series of distinct goods and 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 (1) the customer can benefit from the good or service on its own or together with other readily available resources (i.e., the good or service is capable of being distinct) and (2) the good or service is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract). A promised good or service that an entity determines is not distinct should be combined with other goods or services until a distinct performance obligation is formed.

VSOE of fair value will no longer be required to account for goods and services separately.

The new guidance on identifying separate performance obligations will be a significant change for software entities. Under current software guidance, an entity can separately account for elements in a software licensing arrangement only if VSOE of fair value exists for the undelivered element(s). An entity that does not have VSOE of fair value for the undelivered element(s) must combine multiple elements into a single unit of accounting and recognize revenue as the delivery of the last element takes place.

Licenses of intellectual property

The determination of whether a license is distinct is a significant step in the model and may require judgment. In some software arrangements, a software license will be distinct because it is the only promise in the contract. In other arrangements, the customer can benefit from the license on its own or with readily available resources, and it is separately identifiable from the other goods or services in the contract (i.e., the other goods or services are also distinct). An example is a software package that can be used on its own without customization or modification, and future upgrades are not necessary for the customer to retain continued functionality of the software for a reasonable period of time after the initial free maintenance period.

Licenses that an entity determines are not distinct are combined with other promised goods or services in the contract until a separate performance obligation is identified. In some contracts, the customer can benefit from the license only with another good or service that is promised (explicitly or implicitly) in the contract. For example, a software license may be embedded in a software-enabled tangible good, and the software significantly influences the features and functionality of the tangible good. The customer cannot benefit from the software license on its own, nor is it separable from the tangible good. In these situations, the license is not distinct within the context of the contract and would be combined with those other promised goods or services.

Certain types of software, such as antivirus software, require frequent upgrades to keep the software current in order for it to be beneficial to the customer. Under the new standard, an entity may conclude that such software licenses are not capable of being distinct because the customer cannot obtain the benefit from the software without also obtaining the subsequent upgrades. In these situations, the software license and the unspecified upgrades, together, form a single distinct performance obligation.

Entities also may enter into arrangements with customers that involve significant production, modification or customization of licensed software. Under current software guidance, if an arrangement to deliver a software system requires significant production, modification or customization of the licensed software, the entity accounts for the arrangement in accordance with contract accounting guidance in ASC 605-35.[4] Under the new standard, entities likely will conclude that the software license is not distinct within the context of the contract. That is, the software license and professional services are highly interrelated and significant integration and modification is required and, therefore, the license and services together are a single performance obligation.

Post-contract support

Most arrangements involving software also include promises for the right to receive services or unspecified upgrades and enhancements (or both) after the license period begins. Generally, these services include telephone support and correction of errors (bug fixes or debugging), as well as unspecified upgrades or enhancements. Current software guidance defines these activities as a single element of the arrangement called post-contract support (PCS).

PCS is not a unique service contemplated or defined in the new standard. As a result, entities must evaluate whether the individual services comprising what is considered PCS today will be separate performance obligations. For example, a software entity may conclude that the promise to provide unspecified future upgrades and enhancements is a separate promised good or service in the contract, and a separate performance obligation if it is distinct. This entity also may determine that bug fixes and telephone support are provided to ensure that the software is functioning as promised and, therefore, those services are part of the assurance warranty coverage for the software and are not a revenue element (such warranties will be accounted for under ASC 460[5]).

However, other entities may conclude that the promise to provide telephone support and bug fixes contains elements of both an assurance-type warranty (non-revenue element) and service-type warranty (revenue element), as discussed further in the warranties section below.

Further, when the contract includes a promise to provide unspecified future upgrades and enhancements, the entity must determine the nature of that promise. For example, an entity may conclude that it has established a clear pattern of providing only one significant upgrade or enhancement per year and, therefore, the obligation to provide "future upgrades and enhancements" actually is an obligation to provide this single upgrade or enhancement. Alternatively, if the entity has a history of providing multiple upgrades each year with no discernible pattern of when those upgrades are provided, the entity may conclude that the service represents more of a "stand-ready" obligation.

How we see it

The Boards' explicit elimination of the PCS guidance will require software entities to assess whether the services they now account for as PCS are separate performance obligations. Software entities may need to adjust their systems or create new ones to track and account for any additional performance obligations they may identify for services that they currently account for in a single unit of accounting as PCS.

Specified upgrades

Entities may provide customers with the right to specified upgrades or enhancements as part of a software arrangement. Under the new standard, entities will need to evaluate whether the rights to receive specified upgrades or enhancements are promised goods or services and potentially separate performance obligations. If the specified upgrade is a separate performance obligation, a portion of the transaction price is allocated to it and revenue recognition is deferred until the specified upgrade is provided. This accounting represents a significant change from current practice for specified upgrades and enhancements. Under current practice, because VSOE of fair value is generally unavailable for a yet-to-be-provided upgrade, an entity that includes such a promise in an arrangement is unable to separate the delivered elements from the upgrade. As a result, the upgrade is combined with the delivered elements as a single unit of accounting, and the recognition of the entire arrangement consideration is typically deferred until the specified upgrade is provided.

Unspecified additional software products

As part of a contract with a customer, a software entity may license software today and promise to deliver unspecified additional software products in the future. For example, the software entity may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include PCS in that future deliverables are unspecified. However, under today's guidance, they are distinguished from PCS because the future deliverables are products, not unspecified upgrades or enhancements. Today, the software elements of these arrangements are accounted for as subscriptions. Revenue isn't allocated to any of the individual software products. Instead, all software product-related revenue from the arrangement is recognized ratably over the term of the arrangement beginning with delivery of the first product.

Under the new standard, software entities will be required to determine whether the promise to deliver unspecified additional software products is a performance obligation separate from the license that it delivers. Software entities also will 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.

The standard includes the following example to illustrate the determination of whether goods and services in a software arrangement are distinct:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers—Overall

Illustrations

Example 11 — Determining Whether Goods or Services Are Distinct

Case A — Distinct Goods or Services

606-10-55-141

An entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, an installation service, and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

606-10-55-142

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 606-10-25-19(a) is met.

606-10-55-143

The entity also considers the factors in paragraph 606-10-25-21 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus, the criterion in paragraph 606-10-25-19(b) is met). In particular, the entity observes that the installation service does not significantly modify or customize the software itself, and, as such, the software and the installation service are separate outputs promised by the entity instead of inputs used to produce a combined output.

606-10-55-144

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

a. The software license

b. An installation service

c. Software updates

d. Technical support.

606-10-55-145

The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each of the performance obligations for the installation service, software updates, and technical support are satisfied at a point in time or over time. The entity also assesses the nature of the entity's promise to transfer the software license in accordance with paragraph 606-10-55-60 (see Example 54 in paragraphs 606-10-55-362 through 55-363).

Case B — Significant Customization

606-10-55-146

The promised goods and services are the same as in Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customized to add significant new functionality to enable the software to interface with other customized software applications used by the customer. The customized installation service can be provided by other entities.

606-10-55-147

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) specified in the contract (see paragraph 606-10-25-21(a)). In addition, the software is significantly modified and customized by the service (see paragraph 606-10-25-21(b)). Although the customized installation service can be provided by other entities, the entity determines that within the context of the contract, the promise to transfer the license is not separately identifiable from the customized installation service and, therefore, the criterion in paragraph 606-10-25-19(b) (on the basis of the factors in paragraph 606-10-25-21) is not met. Thus, the software license and the customized installation service are not distinct.

606-10-55-148

As in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract. This is because the customer can benefit from the updates and technical support either on their own or together with the other goods and services that are readily available and because the promise to transfer the software updates and the technical support to the customer are separately identifiable from each of the other promises.

606-10-55-149

On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a. Customized installation service (that includes the software license)

b. Software updates

c. Technical support.

606-10-55-150

The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time.

How we see it

The elimination of the concept of VSOE of fair value as a separation criterion and the potential identification of separate performance obligations for the elements that today are considered PCS will be significant changes for software entities that currently apply the guidance in ASC 985-605. Many software entities have struggled with establishing VSOE of fair value and have had to defer revenue recognition. Under the new standard, they may identify additional performance obligations and recognize revenue earlier than they do today.

Customer options for additional goods or services

Under some contracts, entities provide the customer with the right to future purchases of additional products or services for an amount below fair value. Under the new standard, such options are separate performance obligations only if they provide a material right to the customer that it would not receive without entering into that 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). If an option is determined to be a separate performance obligation, some portion of the transaction price would be allocated to the option, and recognition of the allocated amount would be deferred until the option is exercised (or until such right expires), based on the estimated standalone selling price of the option and the results of a relative selling price allocation.

Under today's software guidance, these discounts are evaluated to determine whether they represent a significant and incremental discount, based on certain criteria. If a significant and incremental discount is determined to exist in the arrangement, the entity must defer the maximum amount of the incremental discount on the future purchase if it is quantifiable. Under the new standard, software entities likely will defer less of the transaction price than they do today.

Considerations for cloud arrangements

Cloud services arrangements may include the cloud services (such as software-as-a-service), or other products or services. These arrangements also frequently include a license to the software that the customer may or may not have the right to take possession of. Cloud services entities also frequently offer professional services such as implementation, data migration, business process mapping, training and project management services, in addition to the cloud service itself. These professional services may be required for a customer to begin using the cloud services in the manner described in the contract.

Customer options for additional goods or services are separate performance obligations if they provide a material right to the customer.

Current software guidance in ASC 985-605 provides a framework for entities to determine whether cloud services arrangements are in the scope of the software revenue recognition guidance or the multiple-element arrangement guidance in ASC 605-25.[6] Essentially, this framework helps entities determine whether they are providing a license of software or a service. While the new standard does not provide the same guidance, it provides a similar framework for identifying the performance obligations in a contract. When an entity determines whether the promised goods or services are distinct, it will have to determine whether it is providing a software license (as a separate performance obligation from the hosting service) or a service (a license and hosting services that together are a single performance obligation because the two promises are not distinct from one another).

In some contracts, the assessment of whether the license is distinct will be relatively straightforward. For example, an entity may provide a customer with a software license, but only in conjunction with a hosting service, and the customer cannot take control of the license or use the software without the hosting service. In this example, the customer cannot benefit from the license on its own and the license is not separable from the hosting services and, therefore, the license is not distinct and would be combined with the hosting service. However, many arrangements are more complex. For example, in some contracts, some of the software (enabling certain functionality) resides on the customer's premises, and the customer has the ability to take control of that software, while other functionality is provided by the hosting service, and the customer cannot take control of that software. As a result, this determination may require significant judgment, depending on the terms of the contract.

Nonrefundable up-front fees

In many transactions, customers may pay an up-front fee at contract inception, which may relate to the initiation, activation or setup of a good to be used or a service to be rendered in the future. Today, when no goods or services are transferred when the fees are paid, the up-front fees are generally recognized over the longer of the contractual term or the estimated customer relationship pursuant to SAB Topic 13.

Under the new standard, entities will continue to evaluate whether nonrefundable up-front fees relate to the transfer of a good or service. In addition, the existence of such fees may indicate that there are other implied elements in the contract, such as the option to renew a service at a discounted rate because the up-front fee would not be charged for the renewal period. In such situations, the identified promised goods and services also should include those implied items.

Under the new standard, the nonrefundable fee ultimately is allocated to the identified performance obligations in the contract (which may include some implied performance obligations) and amounts are recognized as revenue as the performance obligations are satisfied. That is, there is no requirement to treat the nonrefundable up-front fees differently from any other consideration received by the entity as part of the arrangement, as there is in current guidance.[7] By requiring allocation of the up-front fees to the future goods or services or renewal options, rather than recognizing those amounts over the longer of the contractual term or the estimated customer relationship, the standard may cause a change in practice, as illustrated below:

Illustration 3: Nonrefundable up-front fees
Cloud Co. enters into a contract with a customer for a license to its software and a noncancelable one-year subscription to access the licensed application (the cloud services). The contract amount for the software license is an up-front, nonrefundable fee of $1 million, and the fee for the cloud services is $500,000 for one year. The customer has the right to renew the cloud services each year for $500,000. In this example, assume that Cloud Co. determines the software license and cloud services are a single performance obligation. In addition, there are no other promised goods and services in the contract (i.e., the up-front fee is not associated with the transfer of any other good or service to the customer). However, Cloud Co. determines there is an implied performance obligation. That is, the right to renew the cloud services each year for $500,000 is a material right to the customer because that renewal rate is significantly below the rate the customer paid for the first year of service ($1.5 million total). Based on its experience, Cloud Co. determines that its average customer relationship is three years. As a result, Cloud Co. determines that the performance obligations in the contract include the right to a discounted annual contract renewal that the customer is likely to exercise twice.

We discuss options further in the section on allocating the transaction price to performance obligations.

Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be "entitled" and includes an estimate of any variable consideration, the effect of a significant financing component (i.e., the time value of money), the fair value of any noncash consideration and the effect of any consideration payable to the customer. The entitled amount is meant to reflect the amount to which the entity has rights under the present contract and may differ from the contractual price. For example, there may be variable consideration (if the entity expects to receive or accept an amount less than the stated contract amount) or the payment may be received before or after the entity provides goods or services.

Variable consideration

Entities enter into contracts in which a portion of the transaction price could vary because of the contract terms or the entity's intention to act under the contract. For example, such terms could represent discounts or rebates offered or price concessions provided to customers in emerging markets.

The new standard requires an entity to estimate at contract inception any variable consideration in the contract and include such amounts in the transaction price, subject to a constraint. Variable consideration will be estimated using either an "expected value" or "most likely amount" method, whichever better predicts the consideration to which the entity will be entitled. That is, the method selected is not meant to be a "free choice." Rather, an entity needs to consider which method it expects to better predict the amount of consideration to which it will be entitled and apply that method consistently for similar types of contracts.

The estimate of variable consideration is constrained to the amount for which the entity has concluded it is "probable" that a significant reversal in cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. This determination includes considering both the likelihood and magnitude of a revenue reversal. The estimate of variable consideration, including the amounts subject to constraint, is updated at each reporting period.

Under today's software guidance, if a vendor cannot conclude at the outset of the arrangement that the fee is fixed or determinable, revenue is generally recognized either as payments from the customer become due or as rights of return or refund lapse, if all other basic revenue recognition criteria are met. As previously discussed, under the new standard, the transaction price is based on the amount to which the entity expects to be "entitled." While variable consideration is subject to the constraint (as discussed above), entities will be required to estimate variable consideration and include amounts in the allocable transaction price, which could cause them to recognize revenue earlier than today. As a result, more judgment will be required to measure revenue.

Implied price concessions

In certain situations, entities may enter into a contract anticipating that they will be unable to fully collect the stated contractual price. When the entity is aware of that risk and still chooses to transact with the customer, there may be an implied price concession in the contract. Under the standard, any implied price concessions are components of variable consideration, and an entity must estimate these amounts at contract inception. For example, consider a software entity has a history of providing a price concession in a specific region that is 40% of the contract price. When determining the transaction price for an arrangement entered into 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.

This could result in a significant change in practice for entities that currently recognize revenue from customers with these types of fact patterns on a cash basis. Although an entity may determine that the likelihood of an adjustment to the stated contract price is high (e.g., because price concessions are granted), an entity must include its estimate of variable consideration in the transaction price, subject to the constraint, rather than default to deferring all revenue until the contingency has been resolved.

How we see it

Software 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. Software entities will 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. Significant judgment will be required when making this determination and documentation of the judgment should be retained. Software entities should develop clear policies and procedures for these evaluations to ensure consistent application across all transactions.

License arrangements that include sales- or usage-based royalties

Entities commonly enter into arrangements that require the customer to pay consideration based on the sales or usage of a license, such as a percentage of software sales generated by a distributor who has the right to distribute the software over a period of time.

The standard provides an exception from the variable consideration guidance for estimating the variable component of the transaction price related to sales- or usage-based royalties on licenses of intellectual property. The standard requires that this type of variable consideration not be included in the estimate of the transaction price. Instead, the standard requires that these amounts be recognized only upon the later of when the sale or usage occurs or 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).

It is unclear whether this exception will apply to royalties that relate to both licensed intellectual property and other goods or services in a contract (e.g., a contract for a software license that allows the customer to embed the licensor's software in its products but also includes significant customization services up-front that would require the goods and services to be bundled as one performance obligation). The TRG has discussed a number of views, including whether the exception should apply solely to a license that is a separate performance obligation or whether it should apply regardless of whether the royalty also relates to a non-license good or service. It is not yet clear whether the Boards will provide additional guidance.

The treatment of extended payment terms under the new standard may represent a significant change from current practice.

Right of return

A right of return, either explicitly stated in a contract or implied by an entity's customary business practice, is not a separate performance obligation. However, a right of return in a contract creates variability in the transaction price and, therefore, is a form of variable consideration. Under the new standard, an entity will estimate returns and include that estimate as a reduction to the transaction price (subject to the constraint). The entity will recognize the amount of expected returns as a refund liability, representing its obligation to return the customer's consideration. The entity also will recognize a return asset (and adjust cost of sales) for its right to recover the goods returned by the customer measured at the former carrying amount of the inventory, less any expected costs to recover those goods. For many software entities, this amount may be zero because there is no inventory to be returned.

At each reporting date, an entity will remeasure the refund liability and update the measurement of the asset recorded, if any, for any revisions to its expected level of returns, as well as any potential decreases in the value of the products expected to be returned. That is, a returned item should be recognized at the lower of the original cost less the cost to recover the asset or the fair value of the asset at the time of recovery.

Extended payment terms

Under the new standard, when a contract provides the customer with extended payment terms, an entity will need to consider whether those terms create variability in the transaction price (i.e., are a form of variable consideration) and whether a significant financing component exists. We address significant financing components below.

An entity will need to carefully evaluate contracts that include extended payment terms to determine whether the entity has an intention, or a valid expectation, that it will provide a price concession over the financing term. For example, a software entity may have a business practice of providing price concessions in contracts that include extended payment terms in order to negotiate a contract renewal with its customers. Such price concessions are a form of variable consideration, which are required to be estimated at contract inception and deducted from the transaction price.

The current software guidance includes a presumption that extended payment terms (that is, payment terms greater than one year) result in a transaction price that is not fixed or determinable because of an increased risk of the entity granting future price concessions to its customer. As a result, under today's guidance, an entity is restricted from recognizing revenue for arrangements that include extended payment terms unless it can demonstrate it has a history of successfully collecting without making concessions to the customer. The new guidance does not contain this presumption, but it has a relatively high threshold (in the form of the constraint on variable consideration) that must be met before amounts can be included in the transaction price that can be recognized as revenue. However, entities that expect to be entitled to some portion of the consideration due under a contract may be able to recognize revenue earlier than they do today, despite the extended payment terms.

Illustration 4: Extended payment terms

Software Entity X enters into a contract with a customer for a perpetual software license on 30 December 20X3 for $1.5 million. Payment terms are as follows:

- $250,000 due 31 January 20X4
- $250,000 due 30 April 20X4
- $250,000 due 31 July 20X4
- $250,000 due 31 October 20X4
- $250,000 due 31 January 20X5
- $250,000 due 30 April 20X5

Software Entity X's standard payment terms for such arrangements are net 45 days, and the entity has not provided this type of extended payment schedule to customers in the past.

Analysis

Under current practice, Software Entity X would be required to defer revenue because it has no history of offering and collecting from customers with these types of extended terms. In this example, if all of the other basic revenue recognition criteria have been met, Software Entity X would recognize revenue as the payments become due.

Under the new standard, if Software Entity X expected that it would be entitled to the entire transaction amount (i.e., it did not anticipate providing concessions or rebates to the customer), the fixed arrangement fee of $1.5 million would be recognized when control of the software license is transferred.

In contrast, if at contract inception, Software Entity X anticipates that it may provide some amount of concession or discount to the customer because of the extended payment terms, the transaction would include variable consideration, and the entity will need to estimate the transaction price. Software Entity X will consider factors such as the customer's current financial status in estimating the variable consideration. Using an expected value calculation, Software Entity X estimates a transaction price of $1.3 million and also concludes that it is probable that a significant revenue reversal of that amount will not occur. Therefore, the constraint does not reduce the amount of variable consideration included in the estimated transaction price. The entity will need to update its estimate of the transaction price throughout the term of the arrangement to depict conditions that exist at each reporting date.

This illustration does not consider whether a significant financing component exists. We discuss this concept below.

How we see it

Under the new standard, while the existence of extended payment terms in a contract likely creates variability in the transaction price, it might not result in the full deferral of revenue. This likely will be a significant change for software entities that defer the recognition of revenue until cash is collected under today's guidance.

Significant financing component

Entities often enter into arrangements under which the timing of the payment from the customer does not match the timing of the entity's transfer of the goods or services (i.e., the customer pays in advance or in arrears). For example, payments for maintenance are frequently made up front while those services are provided over the contractual term. As previously discussed, contracts also may include extended payment terms.

An entity is required to adjust the transaction price for the time value of money if there is a significant financing component, using the same discount rate that it would use if it were to enter into a separate financing transaction with the customer. The assessment of significance is done at the individual contract level, but the standard does not include guidance as to how this assessment would be made. As a practical expedient, an entity is not required to assess whether the contract contains a significant financing component unless the period between the customer's payment and the entity's transfer of goods or services is greater than one year.

How we see it

Software entities will need to exercise judgment in assessing the significance of the financing component because the standard does not establish quantitative thresholds for significance. The treatment of the time value of money may have a significant effect on long-term contracts, such as multi-year maintenance arrangements with up-front payments. Even entities that don't believe a financing component is significant will need to make a formal assessment. Software companies may be able to alleviate the burden of performing the significance assessment by using a practical expedient the Boards provided.

Consideration paid or payable to a customer

Software entities may agree to compensate a reseller or distributor up to a specified amount for shortfalls in the sales price or reimburse their customers for marketing activities related to certain software products. Consideration payable to a customer is treated 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. The payment for distinct goods and services received should be limited to the fair value of the goods or services, with any amount in excess of the fair value recognized as a reduction of the transaction price.

Entities will need to carefully assess whether the consideration paid to the customer is actually a payment for a distinct good or service or whether it is a reduction of the transaction price for the goods and services the entity is transferring to the customer.

Allocate the transaction price to the performance obligations

Under today's software guidance, a relative selling price allocation is done only when VSOE of fair value exists for all of the elements in the arrangements. However, most software entities do not have VSOE of fair value for all elements. If VSOE of fair value exists for the undelivered elements (typically maintenance and/or professional services), entities apply the residual method to allocate arrangement consideration to the software license.

The new standard requires an entity to allocate the transaction price to each separate performance obligation, generally in proportion to its standalone selling prices (i.e., on a relative standalone selling price basis), with limited exceptions. An entity will need to allocate variable consideration to one or more, but not all, performance obligations in some situations. The standard also contemplates the allocation of any discount in a contract to one or more, but not all, performance obligations, if specified criteria are met.

The standalone selling price is the price at which an entity would sell a good or service on a standalone basis at contract inception. When determining standalone selling prices, an entity must use observable information, if it is available. If standalone selling prices are not directly observable, an entity will need to make estimates based on reasonably available information. The standard discusses three possible estimation methods entities can use: (1) an adjusted market assessment approach, (2) an expected cost plus a margin approach and (3) a residual approach. The use of one or a combination of the methods may be appropriate in estimating the standalone value of a good or service. Further, these are not the only estimation methods permitted.

The requirement to estimate a standalone selling price may be a significant change for entities that currently follow the software guidance in ASC 985-605. That guidance has a different threshold for determining the standalone selling price, requiring observable evidence and not permitting management estimates.

It may be difficult for entities to determine a standalone selling price, particularly for goods or services for which the historical selling price is highly variable (e.g., software licenses) or for goods or services that have not yet been or are never sold separately (e.g., specified upgrade rights for software). The new standard says an entity may be able to estimate the standalone selling price of a performance obligation using a residual approach if: (1) the entity sells the same good or service to different customers for a broad range of amounts (i.e., the selling price is highly variable) or (2) the entity has not yet established a price for that good or service (i.e., the selling price is uncertain).

For example, software arrangements often include a software license, professional services and maintenance services that are bundled together at prices that vary widely. The professional services and maintenance are also sold individually at relatively stable prices. The standard indicates that it may be appropriate to estimate the standalone selling price for the software license as the difference between the total transaction price and the estimated selling price of the professional services and maintenance. In these instances, the results likely would be similar to circumstances for which today's guidance requires a residual approach.

Under the new standard, software entities also will have to change how they estimate the portion of the transaction price that they allocate to options included in software transactions. Specifically, an entity will have to estimate the standalone selling price of an option if the amount is not observable. This estimate may be performed by using a practical alternative provided in the standard when the goods or services are both (1) similar to the original goods and services in the contract and (2) provided in accordance with the terms of the original contract (which may be common for contract renewals). Under this alternative, instead of valuing the option itself, the entity can assume the option is going to be exercised and include the additional goods and services (and related consideration) with the identified performance obligations in the estimated transaction price. The following example demonstrates how the practical alternative could be applied:

Illustration 5: Allocation of the transaction price to an option to renew a contract

Assume the same facts as in Illustration 3. If Cloud Co. determines there is an implied performance obligation to renew the cloud services each year for $500,000, the option would be a material right to the customer because that renewal rate is significantly below the rate the customer paid for the first year of service ($1.5 million total).

Consequently, the renewal options would be separate performance obligations; therefore, Cloud Co. would allocate the $1.5 million transaction price to the identified performance obligations (i.e., the cloud services and the renewal options). The amount allocated to the renewal options would be recognized over the renewal periods. (Note that the amount allocated to the renewal options will likely differ from the stated up-front fee because a portion will be allocated to the services performed in the first year and the remainder allocated to the renewal options.)

Assuming the criteria to use the practical alternative are met, Cloud Co. could value the renewal option by "looking through" to the optional services. Cloud Co. would determine that the total transaction price is the sum of the up-front fee of $1 million, plus three years of cloud service fees ($1.5 million), or $2.5 million. Cloud Co. would then allocate that amount to all of the services expected to be delivered, or three years of cloud services.

Under today's guidance, since entities are generally required to defer and recognize nonrefundable up-front fees systematically over the periods that the fees are earned, Cloud Co. would recognize the $1 million up-front fee over the period of benefit (generally the longer of the contractual relationship or the contract period); the new guidance changes that accounting.

Entities will have to estimate the standalone selling price of an option if the amount is not observable.

Generally, the guidance in ASC 985-605 results in a higher amount of transaction consideration allocated to the option than the approach outlined in the new guidance. This is because ASC 985-605 does not allow an entity to consider the likelihood of exercise of the option and instead requires the entity to account for the discount based on an assumption that the customer will purchase the least amount of products and services that allows it to receive the maximum discount to which it is entitled when VSOE of fair value does not exist. The following example compares the application of the new standard to the guidance in ASC 985-605:

Illustration 6: Allocation of an option for additional software at a discount

Software vendor XYZ enters into a contract to license software products A and B to a customer for a total of $20,000. Software vendor XYZ agrees to provide a discount of $3,000 if the customer licenses products C, D or E within a year of entering the arrangement. The estimated selling price of both products A and B is $10,000. The estimated selling prices of products C, D and E are $10,000, $20,000 and $40,000, respectively. The Software vendor XYZ determines that the future discount provides a material right to the customer because it rarely discounts products C, D or E, and it considers the discount percentage to be significant.

Analysis under the new standard

Software vendor XYZ would allocate the transaction price to the individual performance obligations in the contract, including the option, in proportion to the standalone selling prices of goods underlying each performance obligation. (This would be consistent with current practice for multiple-element arrangements other than software.) Assume Software vendor XYZ concludes that the standalone selling price for the option to purchase future products at a discount is $1,500 based on the potential value of the discount and the likelihood the customer will take advantage of the discount. As a result, the relative selling price allocation would be as follows:

Performance obligation	Estimated stand-alone selling price	Allocated transaction price
Software A	$ 10,000	$ 9,300
Software B	10,000	9,300
Option to purchase future products at a discount	1,500	1,400
		$ 20,000

The amount allocated to the discount would be recognized in revenue when the performance obligation is satisfied (i.e., when the customer purchases products C, D or E or when the option period expires).

Analysis under today's accounting

The accounting treatment under ASC 985-605 depends on whether Software vendor XYZ has established VSOE of fair value for each product.

If VSOE of fair value has been established, Software vendor XYZ allocates the discount proportionately based on the relative VSOE of fair value of products A, B and C. Product C is used for this calculation because Product C has the lowest purchase price and, therefore, results in the largest discount percentage on the aggregate purchase.

Performance obligation	VSOE of fair value	Recognizable revenue (VSOE less discount rate)
Software A	$ 10,000	$ 9,000
Software B	10,000	9,000
Software C	10,000	
	$ 30,000	$ 18,000
Future discount	3,000	
Assumed discount rate in agreement	10%	
Deferred revenue		$ 2,000

If VSOE of fair value does not exist for products C, D or E, ASC 985-605 requires that the maximum amount of the discount, or $3,000, should be deferred until the customer makes a future purchase. However, both of these approaches under ASC 985-605 result in a larger amount (either $2,000 or $3,000) being allocated to the option than would be likely under the new model ($1,400).

How we see it

Under today's software guidance, many entities have difficulty establishing VSOE of fair value for an element, given the level of analysis and rigor involved.

Software entities that follow today's ASC 985-605 will no longer be required to establish VSOE of fair value based on a significant majority of their transactions. As a result, we expect entities will likely use different methods than they currently do to estimate standalone selling prices. Software entities also may find that they are able to use the input data used in their VSOE of fair value analyses to estimate the standalone selling price of a performance obligation. However, it is unclear how much of a change there will be as the result.

Software entities will need robust documentation of the calculations they make in estimating standalone selling prices.

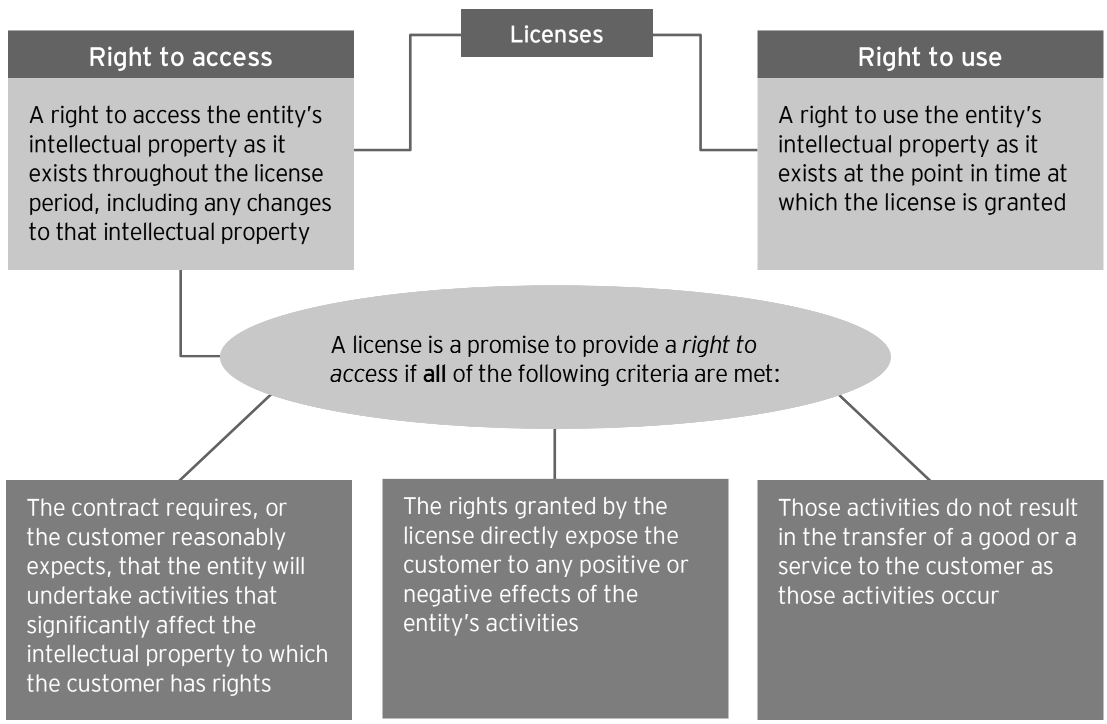
Satisfaction of performance obligations

Under the new standard, an entity recognizes revenue only when it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is considered to be transferred when the customer obtains control. Control of an asset refers to the ability of the customer to direct the use of and obtain substantially all of the cash inflows, or the reduction of cash outflows, generated by the goods or services. Control also means the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service.

Transfer of control for distinct software licenses

The new standard provides additional guidance to help entities determine when control transfers for distinct licenses of intellectual property, based on the nature of the promise to the customer. This guidance is applicable for both perpetual and term software licenses.

The standard states that entities provide their customers with either:



If the license does not meet all three criteria, the license is a right to use by default, and the entity would recognize revenue at the point in time when the license is delivered.

The key determinant is whether the entity is required to undertake activities that affect the licensed intellectual property (or the customer has a reasonable expectation that the entity will do so), and the customer is therefore exposed to positive or negative effects resulting from those changes. These activities must not meet the definition of a performance obligation. However, the activities can be part of an entity's ongoing and ordinary activities and customary business practices (i.e., they do not have to be activities the entity is undertaking specifically as a result of the contract with the customer). Further, the standard notes that the existence of a shared economic interest between the parties (e.g., sales- or usage-based royalties) may indicate that the customer has a reasonable expectation that the entity will undertake such activities.

When an entity is making this assessment (i.e., whether the license is a promise to provide a right to access), it must exclude the effects of any other performance obligations in the arrangement. For example, if an entity enters into a software arrangement with a customer for a software license, unspecified upgrades on a when-and-if available basis and telephone support, the entity first determines whether the license, telephone support and the promise to provide unspecified upgrades are separate performance obligations. If the entity concludes that the telephone support is a warranty element rather than a revenue element, the contract includes two revenue elements: the software license and the unspecified upgrades. Further, if the entity determines that a license is distinct, the entity applies the license implementation guidance to determine whether control transfers over time or at a point in time.

A software license that represents a right to use the software is recognized at a point in time if the entity has no contractual (explicit or implicit) obligation to undertake activities that will significantly affect the software license during the license period beyond any changes and activities associated with the unspecified future upgrade rights. In the above fact pattern, all three criteria for a right to access are not met, and the entity's promise is a right to use the license (and therefore revenue is recognized at a point in time).

The standard includes the following example of a right to use license:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers—Overall

Illustrations

Example 54 — Right to Use Intellectual Property

606-10-55-362

Using the same facts as in Case A in Example 11 (see paragraphs 606-10-55-141 through 55-145), the entity identifies four performance obligations in a contract:

a. The software license

b. Installation services

c. Software updates

d. Technical support.

606-10-55-363

The entity assesses the nature of its promise to transfer the software license in accordance with paragraph 606-10-55-60. The entity observes that the software is functional at the time that the license transfers to the customer, and the customer can direct the use of, and obtain substantially all of the remaining benefits from, the software when the license transfers to the customer. Furthermore, the entity concludes that because the software is functional when it transfers to the customer, the customer does not reasonably expect the entity to undertake activities that significantly affect the intellectual property to which the license relates. This is because at the point in time that the license is transferred to the customer, the intellectual property will not change throughout the license period. The entity does not consider in its assessment of the criteria in paragraph 606-10-55-60 the promise to provide software updates because they represent a separate performance obligation. Therefore, the entity concludes that none of the criteria in paragraph 606-10-55-60 are met and that the nature of the entity's promise in transferring the license is to provide a right to use the entity's intellectual property as it exists at a point in time—that is, the intellectual property to which the customer has rights is static. Consequently, the entity accounts for the license as a performance obligation satisfied at a point in time.

Alternatively, a software license that represents a right to access the software is recognized over the determined access period if an entity concludes that there are activities that will significantly affect the software license during the license period beyond the unspecified future upgrades. That is, while the unspecified upgrades can directly change the intellectual property, other activities also could significantly affect it.

Software entities may find that many licenses of software will represent rights to use the software and the related revenue will be recognized at a point in time. This is because the benefits from the entity's activities in the contract (e.g., unspecified upgrade rights) are promises of service that are separate performance obligations and not contemplated in the assessment for determining the nature of the license. However, entities will need to carefully assess their specific facts and circumstances while also monitoring the Boards', TRG's and AICPA task force's discussions to determine whether licenses should be recognized at a point in time or over time.

Electronic delivery of software

Entities may deliver software to customers electronically by placing the software on their websites for download. In other cases, the customer may be provided with an authorization code to access multiple copies of licensed software. Under today's guidance, if the entity delivers software electronically, the delivery criterion for revenue recognition is met when the customer has the reasonable ability to access the licensed software (or the first copy). This condition generally is met when the entity provides the necessary access code to the customer that allows the customer to begin downloading the licensed software and the entity's server is functioning.

Under the new standard, an entity will first need to determine whether it is transferring the software license over time or at a point in time. If the license is transferred at a point in time, the timing of revenue recognition will likely be consistent with current practice if an entity concludes that control is transferred when it provides the necessary access code to the customer that allows the customer to begin downloading the licensed software and the entity's server is functioning.

Transfer of control for performance obligations excluding distinct licenses

The standard indicates that an entity must determine at contract inception whether it will transfer control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

A performance obligation is satisfied over time if it meets one of the following criteria:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs by providing hosting services, for example.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced. An example would be a promise to develop an IT system on the customer's premises, if the customer controls the system during the development period.
- 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 the performance completed to date. An example would be significantly customizing an asset to the customer's specifications so it is less likely that the entity would be able to use the asset for another purpose (e.g., sell to a different customer) without incurring significant costs to re-purpose the asset, and the entity also has a right to payment for performance completed to date.

If an entity determines that a performance obligation is satisfied over time, it recognizes revenue over the period the performance obligation is satisfied, using an output or input method that best depicts the pattern of the transfer of control over time. Output methods are used to recognize revenue on the basis of units produced or delivered, contract milestones, time elapsed or surveys of services transferred to date relative to the total services to be transferred. The Boards provided a practical expedient for an entity that has a right to payment from a customer in an amount that corresponds directly with the value of the entity's performance completed to date to recognize revenue in the amount for which it has a right to invoice. Software entities may find it appropriate to apply this practical expedient to a professional services contract in which it bills a fixed amount for each hour of service provided. This expedient only applies when the performance obligation is satisfied over time and an output method is used to measure progress.

Input methods are used to recognize revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation relative to the total expected inputs to the satisfaction of that performance obligation. Input methods can include labor hours used, costs incurred, time elapsed or machine hours used. The standard does not indicate a preference for either method; however, it does clarify that the selected method should be applied consistently to similar performance obligations and in similar circumstances.

Although the standard requires an entity to update its estimates related to the measure of progress selected, it does not allow a change in methods. For example, it would not be appropriate for an entity to start recognizing revenue for a performance obligation based on labor hours used and then switch to contract milestones.

For performance obligations that are not transferred over time, control is transferred as of a point in time. For example, when a customer purchases computer hardware, control generally transfers to the customer when the computer hardware is provided. The standard provides indicators to help entities determine when control transfers, including right to payment, legal title, physical possession, risks and rewards of ownership and customer acceptance.

How we see it

Software entities will need to determine the pattern of transfer for a performance obligation satisfied over time. For example, if unspecified upgrades and enhancements are determined to be a performance obligation satisfied over time, the software entity will need to determine an output or input method that best depicts the pattern of transfer of control over time. Based on its experience, the software entity could conclude that unspecified upgrades and enhancements are provided to customers on an annual, quarterly or ad hoc basis. That is, revenue is recognized on the basis of the entity's efforts or another measure that best depicts the pattern of transfer of control, which may not necessarily result in revenue being recognized ratably over the contractual period.

Other measurement and recognition topics

Reseller and distributor arrangements

The new standard could change practice for entities that sell their products through distributors or resellers.

The new standard also could change practice for entities that sell their products through distributors or resellers (collectively referred to in this section as resellers). It is common in the software industry for entities to provide resellers with greater rights than end customers to maintain a mutually beneficial relationship and maximize future sales through the reseller. For example, an entity may provide a reseller with price protection and extended return rights.

Under the new standard, entities will need to first evaluate when control of the product transfers to the customer. To do this, entities may need to first assess whether their contracts with resellers are consignment arrangements, under which control likely would not transfer until delivery to the end customer. The new standard provides three indicators that an arrangement is a consignment arrangement:

- The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.
- The entity is able to require the return of the product or transfer the product to a third party (such as another dealer).
- The dealer does not have an unconditional obligation to pay for the product (although it may be required to pay a deposit).

An entity should not recognize revenue upon delivery of a product to a reseller if the delivered product is held on consignment because control of the product has not transferred. The entity would wait until the reseller sells the product to an end customer to recognize revenue, which would be considered the point in time that the entity has transferred control of the product. The result would be similar to today's practice of deferring revenue recognition until the reseller sells the product to an end customer.

If an entity concludes its contract with a reseller is not a consignment arrangement, the reseller likely will be considered a customer of the entity. The entity would be required to recognize revenue upon the transfer of control of the promised goods in an amount that reflects the amount to which the entity expects to be entitled. Today, many entities wait until the product is sold to the end customer to recognize revenue because they do not meet all of the criteria in ASC 985-605 or SAB Topic 13 to recognize revenue when they deliver the product to the reseller. For example, if an entity cannot reasonably estimate the future price changes resulting from the price protection, the fee would not be considered fixed or determinable, and deferral of revenue would be required until the reseller sells the product to an end customer.

In determining the amount to which they expect to be entitled, software entities will be required to consider whether they will provide resellers with explicit or implicit concessions (e.g., price protection, expanded return rights) that will make the transaction price variable. In these instances, an entity will need to estimate the transaction price and, considering the constraint, include only the amount for which the entity determines it is probable that a significant reversal will not occur. An entity will need to carefully consider whether it can include the variable consideration resulting from the concessions it offers to its reseller customer(s) in its transaction price. The standard indicates that an entity that has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances as a factor that could increase the likelihood (or magnitude) of a revenue reversal. Entities will need to assess the facts and circumstances of their contracts to determine whether current practice will change under the new standard.

Contract costs

In addition to the new revenue guidance in ASC 606,[8] ASC 340-40[9] was added to codify guidance on the accounting for certain costs to obtain and fulfill a contract (or, in some instances, an anticipated contract) with a customer.

Costs of obtaining a contract

Under ASC 340-40, the incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) will be recognized as an asset if the entity expects to recover them. Recovery can be direct (i.e., through reimbursement under the contract) or indirect (i.e., through the margin inherent in the contract). As a practical expedient, the standard permits immediate expense recognition of the contract acquisition costs when the asset that would have resulted from capitalizing such costs would have been amortized in one year or less.

Today, there is diversity in practice for capitalizing costs incurred to obtain a contract because there is limited guidance. Therefore, entities make a policy election to expense such costs as incurred or account for them based on an analogy to the provisions of the guidance related to accounting for separately priced warranty contracts in ASC 605-20[10] or non-refundable fees and other costs in ASC 310-20.[11] Entities that apply ASC 605-20 defer costs that are directly related to the acquisition of a contract if such costs would not have been incurred but for the acquisition of that contract (incremental direct acquisition costs). Entities that apply ASC 310-20 defer certain direct costs incurred in addition to certain incremental costs. Under the new standard, an entity will capitalize all incremental costs that are expected to be recovered, which could differ from the amounts capitalized today.

Entities will need to exercise judgment when determining whether costs incurred in obtaining a contract are incremental (i.e., costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained). The standard cites sales commissions as an example of an incremental cost that may require capitalization under the standard. In contrast, bonuses and other compensation that are based on other quantitative or qualitative metrics (e.g., profitability, earnings per share, performance evaluations) likely do not meet the criteria for capitalization because they are not directly related to obtaining a contract. Entities also may pay commissions upon the renewal of a contract or bonuses based on the achievement of an individual's sales goal or total bookings. Other bonus programs may have escalation provisions under which the bonus amount increases as an individual meets performance targets. The standard provides little guidance about the types of costs that may be considered incremental to obtaining a contract, so this determination may be difficult for entities, particularly when such costs relate to multiple contracts or are incurred over a period of time.

Costs of fulfilling a contract

Entities may incur certain costs to fulfill a contract, such as setup costs in cloud arrangements. An entity will first apply other authoritative guidance to account for such costs (e.g., guidance on development costs of software to be sold, leased or marketed (ASC 985-20), internal-use software (ASC 350-40) and property, plant and equipment (ASC 360)). If such costs are not within the scope of another ASC topic, an entity will apply the new guidance in ASC 340-40. Under this guidance, entities will capitalize the costs to fulfill a contract if the costs relate directly to the contract, generate or enhance the resources used to satisfy performance obligations and are expected to be recovered.

The standard discusses and provides examples of costs that may meet the first criterion for capitalization (i.e., costs that relate directly to the contract), including direct labor, direct materials, allocation of costs directly related to the contract, costs explicitly chargeable to the customer and other costs that are incurred only because the entity entered into the contract.

In order for costs to meet the "expected to be recovered" criterion, costs should be either explicitly reimbursable under the contract or reflected in the pricing on the contract and recoverable through margin. The standard does not specify whether contract costs should be recoverable over the stated contractual period or the period of expected performance (i.e., the customer life). However, because the standard states that the amortization period can exceed the contract period, it is likely that entities will use that longer period in determining whether contract costs should be recoverable (i.e., use the customer life for this determination as well).

The new revenue standard will have a minimal effect on the cost guidance in development costs of software to be sold, leased or marketed (ASC 985-20) and internal-use software (ASC 350-40). Entities should continue accounting for costs within the scope of this guidance as they do so today.

How we see it

Software entities that follow today's software cost guidance mentioned above will continue to do so after the adoption of the new standard. Software entities may have to capitalize additional contract costs if they meet the criteria under the new guidance. The requirement to capitalize costs that software entities expect to recover represents a significant change for entities that currently expense the costs of obtaining a contract.

Because the new revenue standard might change how software entities account for commission expense, they may want to consider revising their current compensation plans.

Amortization and impairment

Current software cost guidance for the development costs of software to be sold, leased or marketed (ASC 985-20) specifies amortization of capitalized costs based on revenues, with an annual minimum based on the straight-line method over the estimated useful life of the software.

Under ASC 340-40, any capitalized contract costs are amortized on a systematic basis that is consistent with the transfer of the goods or services to which the asset relates. The standard permits entities to take into account the expected renewal period in their assessment of the appropriate amortization period.

Any asset recorded by the entity is subject to an ongoing impairment assessment. An impairment exists if the carrying amount of any asset(s) exceeds the unconstrained amount of consideration the entity expects to receive in exchange for providing those goods and services, less the remaining costs that relate directly to providing those good and services.

Warranties

A customer may have the option to separately purchase a warranty on a product (e.g., computer hardware, networking equipment) for a period of time at the point of sale or the warranty may be explicitly stated in the contract. Entities also may provide maintenance services such as bug fixes for a software license that could be considered to be a warranty. The standard identifies two types of warranties:

- Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract (service-type warranties)
- Warranties that promise the customer that the delivered product is as specified in the contract (assurance-type warranties)

If the customer has the option to purchase the warranty separately or if the warranty is not separately priced or negotiated but provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. This type of warranty represents a distinct service and is a separate performance obligation. Therefore, the entity allocates a portion of the transaction price to the warranty based on the estimated selling price of the warranty. Revenue related to the warranty is recognized over the period the warranty service is provided.

Assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a quality guarantee (e.g., to replace or repair a defective product). Such warranties are accounted for under the current guidance on guarantees in ASC 460.

If an entity provides both assurance-type and service-type warranties within an arrangement, an entity is required to accrue for the expected costs associated with the assurance-type warranty and account for the service-type warranty as a performance obligation. If the entity cannot reasonably account for them separately, the warranties are accounted for as a single performance obligation (i.e., revenue would be allocated to the combined warranty and recognized over the period the warranty services are provided).

Next steps

- Entities should perform a preliminary assessment on how they will be affected as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard, even if their accounting results won't change significantly or at all.
- Entities also may want to monitor the discussions of the Boards, the SEC staff, the TRG and the software industry task force formed by the AICPA to discuss interpretations and application of the new standard to common transactions.
- Public entities also should consider how they will communicate the changes with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SAB Topic 11.M.[12] The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available, and the entity should disclose its transition method once it selects it.

Endnotes:

1 ASC 985-605, *Software — Revenue Recognition*.
2 SAB Topic 13, *Revenue Recognition*.
3 ASU 2013-12, *Definition of a Public Business Entity*.
4 ASC 605-35, *Revenue Recognition — Construction-Type and Product-Type Contracts*.
5 ASC 460, *Guarantees*.
6 ASC 605-25, *Revenue Recognition — Multiple-Element Arrangements*.
7 SAB Topic 13, *Revenue Recognition*.
8 ASC 606, *Revenue from Contracts with Customers*.
9 ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*.
10 ASC 605-20, *Revenue Recognition — Services*.
11 ASC 310-20, *Nonrefundable Fees and Other Costs*.
12 SAB Topic 11.M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*.