REVENUE RECOGNITION IN THE TECHNOLOGY INDUSTRY

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1. Introduction

In 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (*Topic 606*)* to provide a robust framework and comprehensive principles for addressing revenue recognition accounting. Additionally, the guidance on accounting for certain costs related to a contract with a customer in the scope of ASC 606 was codified in ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.

While virtually all aspects of ASC 606 and ASC 340-40 are relevant to technology entities, this white paper highlights aspects of the guidance that are particularly pertinent for these entities. For additional information about all of the revenue recognition guidance, including those aspects discussed in this white paper, as well as numerous examples illustrating how to apply the guidance, refer to our revenue recognition guide.

Following the release of ASC 606, the American Institute of Certified Public Accountants (AICPA) organized several industry-specific task forces, including one focused on software, to identify and provide guidance on revenue recognition implementation issues. The culmination of the AICPA task forces' activities was the issuance in 2019 of a final comprehensive nonauthoritative revenue recognition guide (the Revenue Recognition AAG) that provides helpful discussion and illustrative examples on how to apply the guidance.

2. Core principle and key steps

To put the specific aspects of the revenue recognition guidance discussed in this white paper into proper context, it is important to know that the core principle included in the guidance (ASC 606-10-10-2) is to "recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." In addition, the guidance sets out the following steps for an entity to follow when applying the core principle to its revenue-generating transactions:

3. Step 1: Identifying the contract with a customer

A contract is defined in ASC 606-10-25-2 as "an agreement between two or more parties that creates enforceable rights and obligations." To account for a contract in accordance with the guidance, the following five contract existence criteria must be met:

- Approvals have been obtained and a commitment to perform exists on the part of both parties
- Rights of both parties are identifiable
- Payment terms are identifiable
- Commercial substance exists

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- Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur)

When all of the contract existence criteria are met, the remaining steps in the five-step revenue recognition model are applied to the contract. When all of the contract existence criteria are not met, revenue is deferred and the contract existence criteria continue to be evaluated to determine whether they are subsequently met. Absent meeting the contract existence criteria, revenue is only recognized under very limited circumstances, which could result in the initial deferral of revenue for what may be a significant period of time, even if nonrefundable cash has been received.

Entities should focus on whether there are enforceable rights and obligations and whether the contract existence criteria are met. The lack of a signed contract does not affect the recognition of revenue if there are enforceable rights and obligations and the contract existence criteria have otherwise been met. While it is very common for entities in the technology industry to evidence arrangements with signed contracts, a technology entity may continue to provide software-as-a-service (SaaS) or post-contract customer support (PCS) services after an initial contract expires while negotiating the terms of a new agreement. If the entity has a practice of continuing to provide service prior to a new contract being signed and the customer continues to pay under the terms of the original contract, the entity will need to focus on when there are enforceable rights and obligations and when the contract existence criteria are met, which may be before a new contract is executed.

3.1 Evaluating collectibility and price concessions

To meet the collectibility criterion for contract existence, an entity must be able to conclude that collection of substantially all of the amount to which it expects to be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur). For this purpose, only the customer's ability and intention to pay is considered. However, before an entity can determine whether the collectibility criterion is met, it must determine the amount that should be evaluated for collectibility. To do so, there are two primary considerations:

- *Transaction price.* In general, the transaction price does not consider the customer's credit risk, but does consider whether the entity intends to offer the customer a price concession and whether the customer has a valid expectation of receiving a price concession based on the entity's customary business practices, published policies or specific statements. It is not uncommon for certain entities in the technology industry to offer price concessions or extended payment terms to customers, or to sell goods or services to customers that do not have a proven ability to pay the entire contract price. As a result, the transaction price could be less than the contractually stated price.
- *Mitigating credit risk.* An entity should take into consideration its ability to mitigate credit risk related to the transaction price (and, if so, to what extent). This is consistent with the focus of the collectibility criterion on the amount the entity expects to be entitled to for the goods or services that will be transferred to the customer, which may not be all of the promised goods or services in the contract. This is especially common for SaaS entities, which typically have the ability to suspend service immediately in the event a customer stops paying.

Software entities should be particularly diligent when determining the transaction price, as price concessions are more common in this industry due to the relatively low incremental cost associated with licensing a software product. For example, a price concession can take the form of extended payment terms that are subsequently renegotiated to reduce annual payments in later years. Determining whether an amount that is not expected to be collected from a customer results from a price concession or the customer's inability to pay may be difficult. However, appropriately making this determination could significantly affect the timing and amount of revenue recognized in the following ways:

- *Price concession.* The amount that is not expected to be collected due to a price concession is not included in the transaction price (which is the amount ultimately recognized as revenue).

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- *Inability to pay.* When one or more of the contract existence criteria is not met (e.g., the entity cannot conclude that collection of substantially all of the amount to which it will be entitled in exchange for the goods or services that will be transferred to the customer is probable), revenue is deferred and the contract existence criteria continue to be evaluated to determine whether they are subsequently met. Absent meeting the contract existence criteria, revenue only is recognized when the amounts paid by the customer are nonrefundable and one of the following is true:
  - The entity has no remaining performance obligations and it has received all, or substantially all, of the amounts promised by the customer
  - The contract has been terminated
  - The entity has transferred control of the goods or services to which the nonrefundable consideration relates and stopped transferring additional goods or services to the customer and is under no obligation to transfer any additional goods or services

Application of this guidance could result in the initial deferral of revenue for what may be a significant period of time, even if nonrefundable cash has been received.

If all of the contract existence criteria have been met, the remaining four steps would be applied to the contract for purposes of recognizing revenue. If accounts receivable or a contract asset is recognized as a result of applying ASC 606 to the contract, the recognition of any related credit losses is reflected as an allowance for credit losses (and not as a reduction of revenue).

3.2 Accounting for contract modifications

It is common for contracts in the technology industry to be modified, particularly those contracts that span multiple years. For example, a five-year contract in which the entity agrees to provide its customer with a hosted software solution may be modified by the entity and the customer in the contract's third year to add one more year to the contract term.

ASC 606 provides a comprehensive model related to accounting for contract modifications. When a contract modification has been approved, the model results in accounting for the contract modification as a separate contract when it includes both additional promised goods or services that are distinct (see Section 4.2) and additional consideration that reflects the standalone selling prices (see Section 6.2) of the additional promised goods or services adjusted for the contract's specific facts and circumstances. When a contract modification does not meet both of these requirements to be accounted for as a separate contract, it is accounted for as follows:

- *The termination of one contract and execution of a new contract (i.e., prospectively)*, when the contract modification includes only promised goods or services that are distinct from the goods or services that were transferred on or before the modification date and any additional consideration does not reflect the standalone selling prices of the additional promised goods or services adjusted for the contract's specific facts and circumstances.
- *Part of the original contract (which could result in recognition of a cumulative catch-up adjustment)*, when the modified contract includes only promised goods or services that are not distinct.

4. Step 2: Identifying performance obligations in the contract

After contract identification (Step 1), a technology entity needs to identify the performance obligations in the contract (Step 2). Identifying performance obligations in a contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized.

Contracts in the technology industry often include multiple promised goods or services. For example, such contracts may include hardware, installation, software licenses (term or perpetual), PCS, specified

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updates or hosting services. After an entity identifies each of the promised goods or services in the contract, the next step to account for a contract with multiple promised goods or services is to determine whether the promises to provide goods or service should be treated as performance obligations and accounted for separately. This section discusses each of these steps, along with the additional considerations involved in identifying the performance obligations in SaaS or hosted software arrangements and contracts that include options for additional goods or services.

4.1 Identifying promises to transfer goods or services

The first step in identifying the performance obligations in the contract is to identify all promises to provide goods or services. Technology entities should scrutinize their customer contracts to identify all promises to transfer goods or services to the customer. Consideration also needs to be given to whether there are promises to transfer goods or services that arise out of the entity's customary business practices instead of out of an explicit contract provision. For example, paragraph BC87 of ASU 2014-09 notes that when-and-if-available software upgrades may be an implied promised good or service.

Some activities performed by a technology entity in fulfilling a contract do not transfer goods or services to the customer, and thus are not accounted for as a performance obligation. For example, setup activities, such as building an interface between the entity's systems and the customer's systems to allow the customer to access the entity's software product and testing that interface, do not transfer a good or service to the customer. While performing these activities is necessary to provide the promised goods or services in the contract, the activities themselves do not give rise to a promised good or service.

4.2 Separating promises to transfer goods or services into performance obligations

If there is more than one promise to transfer goods or services in a contract, consideration must be given to whether the promises to transfer goods or services should each be considered performance obligations and accounted for separately. The determining factor in this analysis is whether each promised good or service is distinct. A promised good or service is considered distinct if it is capable of being distinct and is distinct within the context of the contract. A promised good or service that is considered distinct is accounted for separately as a performance obligation unless the series exception applies. For additional information about the series exception, refer to Section 6.3 of our revenue recognition guide.

4.2.1 Capable of being distinct

If a customer can benefit from the promised good or service on its own or by combining it with other resources readily available to the customer, the good or service is capable of being distinct. A promised good or service is capable of being distinct when the technology entity regularly sells that good or service separately or when the customer could generate an economic benefit from using, consuming, selling or otherwise holding the good or service for economic benefit either on its own or when combined with other readily available resources. For a resource to be readily available to the customer, it must be sold separately either by the technology entity or another party, or it must be a good or service that the customer already has obtained as a result of either a contract with the technology entity (including the contract under evaluation) or another transaction or event. For example, technical support and software updates for a software product that remains functional without the updates and technical support would be capable of being distinct because 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.

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4.2.2 Distinct within the context of the contract

To determine whether a promised good or service is distinct within the context of the contract, the technology entity must ascertain which of the following best describes its promise within the context of the specific contract:

- *The promise in the contract is to transfer the promised good or service individually*. If this best describes the technology entity's promise within the context of the specific contract, the promised good or service is distinct within the context of the contract.
- *The promise in the contract is to transfer a combined item or items, of which the promised good or service is an input.* If this best describes the technology entity's promise within the context of the specific contract, the promised good or service is not distinct within the context of the contract.

Indicators are provided to assist in determining whether a promised good or service is distinct within the context of the contract. Answering yes to any of the following questions is an indication that the promised good or service is not distinct within the context of the contract:

- Is the technology entity providing a significant service of integrating the promised good or service with one or more of the other promised goods or services in the contract, with the result of that integration being one or more of the combined outputs contracted for by the customer?
- Does the promised good or service significantly modify or customize one or more of the other promised goods or services in the contract, or is the promised good or service significantly modified or customized by one or more of the other promised goods or services in the contract?
- Is the promised good or service highly interdependent or highly interrelated with one or more of the other promised goods or services in the contract, such that each of the promised goods or services is significantly affected by one or more of the other promised goods or services (i.e., can the technology entity satisfy each of the promises in the contract independent of its efforts to satisfy the other promises)?

If a promised good or service is capable of being distinct (see Section 4.2.1) and is distinct within the context of the contract, it is considered a performance obligation and accounted for separately unless the series exception (which is explained and illustrated in detail in Section 6.3 of our revenue recognition guide) applies. If a promised good or service is not distinct, it is combined with other promised goods or services until the group of promised goods or services is considered distinct, at which point that group is considered a performance obligation and accounted for separately. It is possible that all of the promised goods or services in the contract might have to be accounted for as a single performance obligation. This happens when none of the promised goods or services are considered distinct on their own or together with other promised goods or services in the contract.

Additional discussion is provided in Section 4.2.3 related to determining whether a software license is distinct from any other promised goods or services included in the contract.

4.2.3 Additional considerations when accounting for SaaS or hosted software

The accounting for a contract that includes software and hosting services depends at least in part on whether the following criteria are met:

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

If one or both of these criteria are not met, the hosted software arrangement does not include a license of intellectual property (IP) and is accounted for under the general guidance in ASC 606.

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For purposes of determining whether the software and hosting services are distinct from each other and should be treated as one or two performance obligations when both criteria are met, consideration is given to whether the promise to the customer within the context of the specific contract is to transfer the software and hosting services individually (in which case each is a performance obligation accounted for separately) or transfer hosted software to the customer over a period of time to which the software license and hosting services are inputs (in which case the hosted software is one performance obligation). Section 8.1 provides additional discussion related to determining whether a software license is distinct from any other promised goods or services included in the contract.

4.2.4 Additional considerations when accounting for smart devices

Technology companies may sell smart devices that include embedded software, as well as maintenance and support services and cloud-based applications, services or subscriptions. These technology entities must identify their promises and whether or not those promises are distinct and therefore performance obligations, meaning the customer can benefit from the good or service on its own, or by combining it with other resources readily available to the customer, and the promise to transfer the good or service is distinct within the context of the contract. See other sections of Chapter 4 for additional guidance on identifying performance obligations. For smart devices with embedded technology, a technology entity should consider the guidance in ASC 606-10-55 to 56, which provides the following examples of when a software license would not be considered distinct from the related good or service:

- A license that forms a component of a tangible good that is integral to the functionality of the good
- A license that the customer can benefit from only in conjunction with a related service (such as an online service provided by the entity that enables, by granting a license, the customer to access content)

When the sale of a smart device also includes maintenance and support services as well as cloud-based services or subscriptions, the technology entity should evaluate the indicators from Section 4.2.2 to determine whether the services are distinct within the context of the contract. Consideration should be given to the following questions, among others:

- Does the entity provide integration services?
- Does the service modify or customize the smart device?
- Does the use of the smart device rely upon, or is it interdependent with, maintenance and support or a cloud-based subscription?
- Can the customer use the smart device on its own without the other services?
- Does the technology entity have a history of selling the smart device without the associated services?

4.3 Customer options for additional goods or services

As part of a contract, a technology entity may provide the customer with options for additional goods or services, such as an option to purchase additional goods or services in the future at a discount or a contract renewal right that can be exercised in the future.

As discussed in more detail later in this section, if an option provides a material right to the customer that the customer would not have received without entering into the contract with the technology entity, the option itself is a performance obligation. In other words, the goods or services that would be provided to the customer if the option were exercised are not identified as promised goods or services or performance obligations, and the transaction price does not include the amounts to which the technology entity would expect to be entitled in exchange for transferring control of any promised goods or services the customer elects to purchase upon exercising the option.

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It is fairly common in the technology industry for a contract to include an option to purchase additional copies of, or allow additional users access to, software previously sold to a customer. As noted in paragraph 9.2.16 of the Revenue Recognition AAG, when an entity provides customers with the right to purchase additional or incremental rights to software that the customer did not previously control, that should be considered an option. In contrast, when an entity is entitled to additional consideration from a customer based on the level of usage of software that it already controls, the usage-based payments should be considered variable consideration. In many cases, distinguishing between an option and variable consideration will require significant judgment.

It is also very common in the technology industry (particularly in SaaS or maintenance contracts) for a contract to include an option to renew the contract at potentially favorable rates once the initial contract term expires or offer an option to purchase multiple renewal periods at once for a discount. These renewal options must be evaluated to determine whether they represent a material right to the customer that it would not have received without entering into the contract with the entity. If the renewal option represents a material right, it is a performance obligation, and a portion of the transaction price is allocated to it. The presence of a significant nonrefundable upfront fee paid on initial signing of a contract but not charged on renewal may also trigger a material right, as discussed in Chapter 9.

Making the determination as to whether an option for additional goods or services represents a material right and thus a performance obligation requires significant judgment. In addition, if such an option should be treated as a performance obligation, estimating its standalone selling price for allocation purposes (see Section 4.3.4) could be quite difficult. However, there is a practical alternative provided in ASC 606 that allows an entity in certain circumstances to allocate a portion of the transaction price to the optional goods or services based on the consideration to which the entity expects to be entitled for the goods or services that are expected to be provided. Entities in the technology industry that include options for additional goods or services in their contracts need to ensure they have processes in place to track and evaluate these options to ensure compliance with ASC 606.

4.3.1 Determining whether a contract includes a customer option for additional goods or services or variable consideration

In many cases, determining whether a contract includes a customer option for additional goods or services will be relatively straightforward. However, in other cases, such as those in which the contract has variable attributes, it may not initially be clear whether those variable attributes give rise to an option for additional goods or services or variable consideration.

Understanding the technology entity's and the customer's rights and obligations is critical to determining whether the variable attributes in a contract should be accounted for as an option or variable consideration. The following table captures the rights and obligations of the technology entity and the customer that point to the variable attributes in a contract being either an option or variable consideration for accounting purposes:

Points to variable attributes in a contract being…	
An option	**Variable consideration**
The technology entity is not obligated to transfer additional promised goods or services unless and until the customer exercises its right to purchase those additional goods or services.	The technology entity is obligated to provide the promised goods or services without the customer exercising an incremental right. The action taken by the customer is resolving the uncertainty of how much it will pay.
The customer becomes obligated to transfer additional consideration to the technology entity only after it both exercises its right to purchase	The customer becomes obligated to transfer additional consideration to the technology entity after (or as) it obtains control of the promised

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Points to variable attributes in a contract being…	
An option	**Variable consideration**
additional promised goods or services and takes control of those goods or services.	goods or services transferred by the technology entity.
Actions taken by the customer obligate the technology entity to provide additional promised goods or services.	Actions taken by the customer serve to resolve the uncertainty related to the amount of consideration it is obligated to pay.

While in some situations there will be minimal differences between accounting for the variable attributes in a contract as an option instead of variable consideration (or vice versa), it remains important in those situations to reach the appropriate conclusion, given the disclosure requirements in ASC 606. For example, if the contract includes an option that is accounted for as a performance obligation, the technology entity would be required to include the option in its disclosure requirements about its performance obligations. Conversely, if the contract includes variable consideration, the technology entity's disclosures about the transaction price allocated to the remaining performance obligations would be affected (unless the entity is eligible for and elects an available practical expedient).

Example 4-1: Determining whether the variable attribute in a contract gives rise to an option or variable consideration (Question 18 of FASB's Revenue Recognition Implementation Q&As)

The FASB staff and TRG concluded the following two examples include single performance obligations and variable consideration (and not options):

Example A (excerpt):

Information Technology (IT) Seller and IT Buyer execute a 10-year IT Outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term. For example, the vendor will provide server capacity, manage the customer's software portfolio, and run an IT help desk. The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power (MIPs), number of software applications used, or number of employees supported, and the price per unit differs for each type of activity. Before the delivery of the service, IT Seller performs certain initial set-up activities to be in a position to provide the other services in the contract. IT Seller charges the IT Buyer a nonrefundable upfront fee related to the transition activities. IT Seller concludes that the set-up activities do not transfer services to the customer.

Example B (excerpt):

Transaction Processer (TP) enters into a 10-year agreement with a customer. Over the 10-year period, TP will provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use TP's system to process all of its transactions; however, the ultimate quantity of transactions is not known. TP concludes that the customer simultaneously receives and consumes the benefit as it performs. TP charges the customer on a per transaction basis. For each transaction, the customer is charged a contractual rate per transaction and a percentage of the total dollars processed. TP also charges the customer a fixed upfront fee at the beginning of the contract.

RSM COMMENTARY: The conclusions reached in these examples are directly tied to the FASB staff's conclusions that a single performance obligation exists in each example. If different conclusions were reached about the nature and number of performance obligations

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present in the example, different conclusions may be reached about how to account for the variable attributes of the contracts.

In Example A, the entity is obligated to transfer continuous integrated IT services to the customer. The customer does not have an option to buy these IT services; it has committed to buying the services. The entity has no additional obligations to the customer beyond transferring control of the IT services. The customer does not have an option to buy any other goods or services from the entity. The customer's obligation to pay the entity arises as it obtains control of the IT services (i.e., as it uses the services). The action taken by the customer is using the IT services (not exercising an option to buy additional services), which is resolving the uncertainty related to the amount of consideration it is obligated to pay. Based on the nature of the parties' rights and obligations, the variability in how much the customer will use the IT services gives rise to variable consideration (and not an option). For discussion related to the accounting for the transition (e.g., setup) activities and upfront nonrefundable fee, see Section 6.1.4 and Section 7.1.2, respectively, of our revenue recognition guide.

In Example B, the entity is obligated to transfer continuous transaction processing services to the customer. The customer does not have an option to buy these services; it is committed to buying the services. The entity has no additional obligations to the customer beyond transferring control of the transaction processing services. The customer does not have an option to buy any other goods or services from the entity. The customer's obligation to pay the entity arises as it obtains control of the transaction processing services (i.e., as it sends transactions to the entity for processing). The action taken by the customer is using the transaction processing services it is committed to buy (not exercising an option to buy additional services), which is resolving the uncertainty related to the amount of consideration it is obligated to pay. Based on the nature of the parties' rights and obligations, the variability in how much the customer will use the transaction processing services gives rise to variable consideration (and not an option). For discussion related to the accounting for the upfront nonrefundable fee, see Section 7.1.2 of our revenue recognition guide.

4.3.2 Determining whether customer options for additional goods or services are performance obligations

The question that arises when a technology entity includes an option for additional goods or services in a contract is whether that option is a performance obligation that should be accounted for separately. The answer to this question hinges on whether the option provides a material right to the customer that it would not have received without entering into the contract with the technology entity. In general, if an option included in a contract gives the customer the right to a discount that is incremental to the range of discounts typically given by the technology entity on the same goods or services to the same class of customer in the same geographical area or market, the option provides a material right to the customer that it would not have received without entering into the contract. Conversely, if an option included in a contract gives the customer the right to purchase products or services at their standalone selling prices in the future, the option does not provide a material right to the customer that it would not have received without entering into the contract. This type of option is essentially a marketing offer that is not accounted for until the customer exercises the option.

When evaluating whether an option provides a material right, the technology entity should take into consideration all transactions, including current, past and future transactions with the customer that are relevant to the evaluation.

A question that arises when evaluating whether an option provides a material right is whether the technology entity should consider only quantitative factors or both quantitative and qualitative factors. The

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FASB staff and Transition Resource Group (TRG) discussed this question. A summary of their discussion was provided in Question 13 of FASB's Revenue Recognition Implementation Q&As. The FASB staff and TRG concluded that both quantitative and qualitative information should be considered by an entity when evaluating whether an option provides a material right. Consider the following example.

Example 4-2: Evaluating whether a nonrefundable upfront fee and contract renewal right result in an option that provides the customer with a material right (Question 13 of FASB's Revenue Recognition Implementation Q&As)

Example 2

Entity A and Customer Y enter into a 12-month service contract for $60 per month. All customers are required to agree to a 12-month contract. In addition to the monthly fee, Customer Y also must pay a $120 nonrefundable fee at contract inception. The upfront fee is not considered to transfer a promised good or service. Customer Y will only pay the $120 fee once as long as it continuously remains a customer of Entity A. Entity A's customers have multiple service providers available to them in their geographic area. While monthly service fees are similar throughout the geographic area, some of those service providers do not charge customers upfront fees to initiate services for customers who are existing customers of a competitor.

The contract also contains a renewal option that allows Customer Y to renew the contract on a month-to-month basis. The contract does not stipulate the renewal price, but Entity A does not operate in a volatile industry and service rates have historically remained relatively stable (that is, the monthly fee is not expected to significantly increase or decrease). As a practical alternative to estimating the standalone selling price of the renewal option, Entity A evaluates the renewal option by reference to the services provided (in accordance with paragraph 606-10-55-45).

Entity A would evaluate the quantitative factors based on an evaluation of whether its customers receive a material right with respect to renewal of the services because they do not have to pay an additional $120 upfront fee at the beginning of the renewal period. In this case, Entity A would consider whether the renewal price that Customer Y will pay (that is, $60/month) compared with the allocated price that a new customer would pay for the same services ($120/12 = $10 + $60/month fee = $70) provides the customer with a material right. Entity A would also consider qualitative factors such as the availability and pricing of service alternatives. For example, Entity A might consider the fact that after the one-year fixed term, Customer Y could get substantially similar services from one of Entity A's competitors at the same price as it would receive those services from Entity A (that is, $60/month). This might call into question whether the option to renew Entity A's services at $60/month provides Customer Y with a material right that it would not have received without entering into the initial services contract with Entity A.

RSM COMMENTARY: This example illustrates that the entity should take into consideration more than just quantitative information when evaluating whether payment of an upfront nonrefundable fee together with the contract renewal right provides the customer with a material right. In other words, it also should consider qualitative information, such as whether its competitors charge an upfront nonrefundable fee. Chapter 9 discusses the accounting for nonrefundable upfront fees.

4.3.3 Accounting for an option that is a performance obligation

When an option is a performance obligation, a technology entity must determine the standalone selling price for the option for purposes of allocating a portion of the transaction price to the option (see Section 4.3.4). In addition, the transaction price does not include any additional consideration that would result from the customer exercising the option because the option is a material right that the customer is

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implicitly obligated to pay for as part of the contract in which it is included. The transaction price allocated to the option is recognized as revenue when or as the option is exercised (see Section 4.3.5), or if it is not exercised, when the option expires unused. This accounting model essentially reflects the customer partially paying in advance for goods and services it will purchase when it exercises the option.

4.3.4 Estimating the standalone selling price of an option that is a performance obligation

While unlikely to be the case, if there is a directly observable standalone selling price for the option, it should be used for allocation purposes. For the more likely scenario in which a directly observable standalone selling price for the option is not available, the technology entity must estimate the standalone selling price (which is discussed in detail in Section 8.2 of our revenue recognition guide). In doing so, the technology entity should ensure that the estimate reflects both of the following:

- *If the customer could get a discount without exercising the option, that discount should be taken into consideration in the standalone selling price of the option.* For example, consider a situation in which a customer has an option to purchase product from the technology entity in the future at a 30% discount. If the customer could get a 10% discount on future purchases of the product without the option because, for example, the technology entity is offering a 10% discount on future purchases of any product to all customers, that should be taken into consideration in estimating the standalone selling price of the option. In this situation, the discount that should be evaluated to determine whether it provides the customer with a material right is the incremental 20% discount on future purchases that the technology entity is offering to only this customer. This is important to keep in mind because the effects of the customer only getting an incremental discount of 20% (compared to 30%) decreases the value of the option, all other things being equal.
- *How likely it is that the customer will exercise the option.* For example, consider a situation in which a customer has an option to purchase up to $1,000 of hardware from the technology entity in the future at a 30% discount. If the customer is only expected to use the discount to purchase $800 of product, the standalone selling price of the option should reflect the expected purchases of $800 and not the maximum possible purchases of $1,000.

Given the difficulties that may arise in estimating the standalone selling price of an option for additional goods or services, a technology entity may instead allocate a portion of the transaction price to the optional goods or services based on the goods or services expected to be provided in connection with the option and the related expected consideration. However, this practical alternative may only be elected if the optional goods or services are similar to the original goods or services in the contract and provided in accordance with the terms of the original contract.

While a contract renewal option is the most likely type of option to qualify for this practical alternative, other types of options also may qualify.

4.3.5 Accounting for the customer’s exercise of an option that provides a material right

The FASB staff and TRG discussed how a technology entity should account for the customer’s exercise of an option that provides a material right. For this purpose, the FASB staff and TRG concluded that two models are supportable under ASC 606. One of the models is based on continuing to account for the performance obligations previously identified in the contract as they otherwise would have been accounted for absent exercise of the option, and separately accounting for the performance obligations created by the customer’s exercise of the option. The other model is based on the change in scope or price resulting from exercise of the option being evaluated as a contract modification. A technology entity must elect an accounting policy related to which model it will use to account for the customer’s exercise of an option that provides a material right, disclose that accounting policy and consistently apply it in similar facts and circumstances. It is worth noting that the TRG and FASB staff considered and rejected a view that the customer’s exercise of an option that provides a material right should (or may) be accounted for as variable consideration. They did not believe this view was supportable under ASC 606.

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Additional information about (and an example illustrating) each of the supportable models is provided in Section 6.6.3.2 of our revenue recognition guide.

4.4 Additional considerations when a third-party is involved in delivery of good or service

When another party is involved with the technology entity in providing the specified goods or services to the customer, the principal vs. agent guidance must be applied. Technology entities often sell products or services through a reseller. A reseller of technology products or services therefore will need to evaluate whether it is the principal or agent. There are two key steps in the principal vs. agent guidance:

- Identifying the specified goods or services being provided to the customer
- Determining whether the entity obtains control of the specified goods or services before transferring control of those goods or services to the customer

Additionally, a technology entity selling through a reseller should consider whether the reseller is the principal or agent to determine whether its customer or the reseller is the end user.

5. Step 3: Determining the transaction price

5.1 General requirements for determining the transaction price

Transaction price is defined in ASC 606-10-32-2 as “the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes).” A technology entity may elect an accounting policy under which it excludes from the transaction price taxes it collects from its customers that were assessed by a government authority on (or contemporaneous with) the technology entity’s revenue-generating transactions with its customers. Examples of taxes to which this accounting policy would apply if elected are sales taxes, use taxes, value-added taxes, excise taxes and other similar taxes. Examples of taxes to which this accounting policy would not apply if elected are gross receipts taxes and taxes imposed during the inventory procurement process.

If a technology entity elects this accounting policy, it must apply the policy to all sales and similar taxes. In other words, the technology entity cannot choose to apply the policy to some sales and similar taxes and not apply the policy to other sales and similar taxes. In addition, if the technology entity elects the accounting policy, the accounting policy disclosure requirements in ASC 235 apply.

If a technology entity does not elect the accounting policy, it must determine whether it is a principal or an agent with respect to each sale or similar tax assessed on its revenue-generating transactions. If it is a principal, the sales or similar tax is included in the transaction price. If it is an agent, the sales or similar tax is not included in the transaction price. Making the determination as to whether the entity is a principal or an agent with respect to each sale or similar tax in every tax jurisdiction in which its revenue-generating transactions are subject to such taxes could be a very onerous exercise. It is for this reason that the FASB provided the alternative accounting policy.

5.2 Accounting for variable consideration

Variable consideration can take many forms. In the technology industry, common examples include early payment discounts, rebates, price concessions and sales- or usage-based royalties. The variability in the amount of consideration to which the technology entity is entitled may be caused by explicit terms in the contract or it may be caused by an implicit price concession, discount, refund or credit that the technology entity intends to offer the customer, or which the customer has a valid expectation of receiving based on the technology entity’s customary business practices, published policies or specific statements.

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There are certain scenarios in which an entity may not be required to estimate variable consideration:

- An entity provides a series of distinct good or services for which the variable payments relate specifically to the entity's efforts to transfer each distinct good or service within the series (see Section 8.3.2.1 5 of our revenue recognition guide)
- An entity is entitled to sales- or usage-based royalties and the only, or predominant, items to which the royalty relates is the license of IP (see Section 7.3.5 of our revenue recognition guide)
- An entity elects to apply the practical expedient that allows revenue to be recognized for the amount the entity has a right to invoice (see Section 9.3.1.1 of our revenue recognition guide)

Outside of these exceptions, an estimate of the amount of variable consideration to which a technology entity expects to be entitled should be included in the transaction price to the extent it is probable that its inclusion will not result in a significant reversal of cumulative revenue recognized when the uncertainty giving rise to the variability is resolved. This approach to determining the amount of variable consideration that a technology entity should include in the transaction price suggests the following steps should be performed:

1. Estimate the amount of variable consideration to which a technology entity expects to be entitled using either the expected value method or the most likely amount method (the specific method used depends on which will better predict the amount of variable consideration in a particular set of facts and circumstances)
2. Constrain the estimated amount of variable consideration such that it is probable that the inclusion of the estimate in the transaction price will not result in a significant reversal of cumulative revenue recognized for the contract when the uncertainty giving rise to the variability is resolved

While these appear to be two discrete steps, as discussed in Question 7Q.3.3.1 of our revenue recognition guide, a technology entity's use of the expected value method to estimate the variable consideration to which it expects to be entitled may, depending on the facts and circumstances, reduce the probability of a revenue reversal such that the technology entity does not have to separately constrain its estimate of variable consideration.

The estimate of variable consideration must be reassessed each reporting period until the underlying uncertainty is resolved. Any changes in the estimate of variable consideration are treated the same as any other changes in the transaction price. The method used to initially estimate the variable consideration included in the transaction price also should be used when the estimate is reassessed each reporting period.

As discussed in Section 4.3.1, when a contract has variable attributes, it may not initially be clear whether those variable attributes give rise to an option for additional goods or services or variable consideration. Additional discussion and examples are provided in Section 4.3.

5.3 Significant financing component

It is not uncommon for contracts in the technology industry to include either deferred or advance payment terms. For example, an entity may not require payment for a three-year software license until sometime during the second year of the license, or an entity may require a customer to pay a large upfront fee in a multi-year contract that includes a software license and PCS.

In determining the transaction price, technology entities must consider whether these terms result in a significant financing component. The guidance in ASC 606 addresses both deferred and advance payment terms, which means a significant financing component in a contract could result in the entity recognizing interest income or expense.

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Technology entities also should note that a significant financing component does not exist in any of the following situations:

- The customer makes an advance payment and the promised goods or services are transferred to the customer at the customer's discretion
- There is substantial variable consideration, and payment of that consideration is contingent on the resolution of an uncertainty that is not substantially in the entity's or customer's control
- There are reasons not related to financing that justify the nature and amount of the difference between the cash selling prices of the promised goods or services and the promised consideration

Determining whether a significant financing component exists in a contract requires exercising judgment and careful consideration of all the facts and circumstances, and may be particularly relevant for SaaS contracts, for which performance obligations are typically satisfied over time and a significant upfront fee is charged.

If, after careful consideration of the facts and circumstances, a technology entity determines that a contract has a significant financing component, a practical expedient to ignore that financing component when estimating the transaction price can be applied if the entity expects the difference between the following two events to be one year or less at contract inception: (a) the entity's transfer of the promised goods or services to the customer and (b) customer payment for those goods or services. When assessing whether the practical expedient can be applied, it is important to focus on these two events and not the duration of the contract in its totality.

5.3.2 Impact of contract modifications on significant financing components

As previously noted, it is common for contracts in the technology industry to be modified, particularly contracts that span multiple years, which are more likely to include a significant financing component. Contract modifications that change the timing of payment or the satisfaction of the performance obligations could result in a significant financing component that was not present in the original contract. As noted in paragraph 9.3.23 of the Revenue Recognition AAG, when a contract is modified, an entity should consider whether a significant financing component is present based on the terms and conditions of the newly modified contract. While the guidance in ASC 606 states that entities should not adjust the financing component for changes to interest rates or other circumstances after contract inception, Paragraph 9.3.25 of the Revenue Recognition AAG makes it clear that this is not meant to apply to situations in which a contract is modified, and entities should use discount rate assumptions in place at the time of the modification.

6. Step 4: Allocating the transaction price to the performance obligations

6.1 Overall allocation model

Step 4 of the five-step revenue recognition model in ASC 606 requires an entity to allocate the transaction price (determined in Step 3) to each performance obligation in the contract (identified in Step 2).

The overall objective of the guidance on allocating the transaction price is to allocate an amount to each performance obligation (or distinct good or service in a single performance obligation resulting from the series exception [refer to Section 6.3 of our revenue recognition guide]) that represents the consideration to which the entity expects to be entitled as a result of transferring control of the underlying goods or services to the customer.

If a contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance

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obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Exceptions are provided for certain situations involving discounts or variable consideration that can be shown (by meeting certain criteria) to be related to one or more (but less than all) performance obligations. Those exceptions are discussed in Section 6.3 of this whitepaper and Section 8.3.1 of our revenue recognition guide.

6.2 Standalone selling prices

The standalone selling price of a performance obligation is the amount the technology entity charges (or would charge) when the distinct goods or services that make up the performance obligation (i.e., the underlying distinct goods or services) are sold on their own to a customer. Standalone selling prices are determined at contract inception and are not subsequently adjusted for changes in facts and circumstances.

The best evidence of the standalone selling price of the underlying goods or services is the observable price charged by the technology entity for those goods or services when they are sold separately in similar circumstances to similar customers. Absent evidence of a directly observable standalone selling price, the technology entity is required to estimate a standalone selling price. This is especially likely to be common in the software industry where many software vendors only sell software licenses bundled with PCS. While there are any number of approaches to estimating a standalone selling price that are consistent with the overall objective of allocating the transaction price, ASC 606 discusses the following three approaches:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach

A residual approach may only be used when there is an observable standalone selling price for the other performance obligations in the contract and one of the following criteria is met:

- The prices at which the technology entity has sold the goods or services on a standalone basis at or near the same time represents a broad range of prices within which a representative standalone selling price cannot be identified (i.e., the selling price is highly variable)
- The goods or services underlying a performance obligation have not previously been sold on a standalone basis and the technology entity has not yet established a price for those goods or services (i.e., the selling price is uncertain)

In making this estimate, the entity should maximize observable inputs and consider all reasonably available and relevant information, including information specific to the entity, the market, the customer and the customer class. In addition, an entity should be consistent in how it applies an estimation method and the situations in which it applies an estimation method.

The type of information used to estimate standalone selling price will vary significantly across industries and entities and even within an entity based on the products or services offered. Paragraph 9.4.31 of the Revenue Recognition AAG provides examples of the types of information that a technology entity may consider in developing an estimate. The following list is not all inclusive, but includes data that may be helpful to consider as entities develop estimates of standalone selling price.

- *Historical selling prices.* Even if limited standalone sales exist, historical pricing may still be relevant in determining an estimate for current standalone selling price. For example, standalone renewal sales of software maintenance may be an appropriate data point to use when estimating the standalone selling price of maintenance in an initial combined contract including both software and maintenance services

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- *Competitor pricing for similar products.* For entities that operate in highly competitive markets with relatively homogenous goods, competitors' pricing may be helpful in developing an estimate of standalone selling price
- *Entity's pricing for similar products.* Entities that have observable standalone selling prices for similar products may be able to use that pricing as a starting point, adjusting for differences in functionality and features
- *Industry or entity pricing practices.* Entities typically will have certain pricing or profit objectives and methods of developing pricing for products or similar products. For example, when prices are developed based on costs incurred plus a target profit margin, a cost-plus-margin approach may be used to estimate a standalone selling price.
- *Effect of proposed transaction on pricing and the class of the custome*r. Entities should consider the size of the deal, the characteristics of the targeted customer, the geography of the customer and the attractiveness of the market in which the customer resides when developing an estimate of standalone selling price
- *Published price lists.* While price lists cannot be assumed to be equivalent to standalone selling price, they may be a useful data point to estimate a standalone selling price
- *Valuation techniques.* In some cases, the use of a valuation technique, such as estimating the value of intellectual property using expected future cash flows based on a reasonable royalty rate, may be appropriate

The data points accumulated by an entity should be considered in conjunction with one another. In other words, an entity should not just select a single data point and determine their best estimate of selling price based on that alone.

It is especially common for software companies to lack observable sales or comparable third-party or industry pricing. As a result, entities may have to focus more on entity-specific factors when estimating standalone selling price. As noted in paragraph 9.4.44 of the Revenue Recognition AAG, some entities may conclude that they have established a value relationship between a software product and the maintenance that is helpful in determining standalone selling price. For example, an entity that sells perpetual licenses bundled with the first year of maintenance and that sells subsequent maintenance renewals on a stand-alone basis may conclude that the established practice of pricing and selling maintenance as a percentage of the net fee for related software licenses indicates the entity has established a value relationship between the software and maintenance that provides insight into the stand-alone selling price for each element on its own.

Entities also may begin with the standalone selling price of a similar item when developing an estimate. For example, perpetual and term licenses often are bundled with maintenance. As noted in paragraph 9.4.51 of the Revenue Recognition AAG, a software company that has established a value relationship between a perpetual software license and maintenance services may use that as a starting point to establish the standalone selling price for maintenance associated with a term license without renewal pricing and then adjust for any facts and circumstances that might cause the standalone selling price of the maintenance to differ based on the type of license with which it was associated.

Additionally, because many technology companies do not consistently sell products or services at the same price, it may be appropriate for an entity to use a range as an estimate of the standalone selling price. However, the range should be sufficiently narrow so that any price within the range represents a price that the entity would accept if the product or service were sold regularly on a standalone basis. For example, if an entity has observable data showing that recent standalone sales of installation services were priced at 60% to 70% of the entity's list price, and over 50% of bundled transactions were priced at 40% to 60% of the entity's list price, paragraph 9.4.39 of the Revenue Recognition AAG indicates it likely would not be appropriate for the entity to conclude that its standalone selling price is a range of 40% to

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70% of the list price. Instead, the entity would have to consider the relative importance of all available data to determine a reasonably narrow range, likely considering the standalone sales data as more relevant. Continuing with this example, the entity may determine that while over 50% of its transactions were priced at 60% to 70% of the list price, it could expand the estimate of standalone selling price to 40% to 80% of the list price in order to encompass 75% of its transactions. However, paragraph 9.4.39 of the Revenue Recognition AAG indicates that it would not be appropriate to expand the range simply to cover a higher percentage of the population. In order to comply with the objective of allocating the transaction price in an amount that depicts consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer, the range must be reasonably narrow such that any price within the range represents a price that the entity would accept if the product or service were sold on a standalone basis.

Once a range is established, entities also must select a reasonable and systematic approach when allocating the transaction price when the stated contractual price for a distinct good or service is outside of that range. Paragraph 9.4.41 of the Revenue Recognition AAG indicates that the use of a consistent point in the range, such as the midpoint of the range, would be appropriate, as long as the overall allocation objective in ASC 606-10-32-28 is still met.

6.3. Allocating variable consideration

Variable consideration included in the transaction price should be allocated on a proportionate basis to each of the performance obligations in a contract, except when the following two criteria are met:

- The terms of the variable payment are specifically related to the technology entity’s efforts to satisfy, or achieve a specific outcome from satisfying, a specific performance obligation, or transfer, or achieve a specific outcome from transferring, a distinct good or service in a single performance obligation resulting from application of the series exception
- Allocating the variable payment to the specific performance obligation, or distinct good or service in a single performance obligation resulting from the series exception, depicts the amount of consideration to which the technology entity expects to be entitled in exchange for transferring that good or service to the customer when considering all of the performance obligations and payment terms in the contract

When these criteria are met, the variable payment included in the transaction price that meets these criteria, and any change in the estimate of that payment, should be allocated in their entirety to the specific performance obligation or distinct good or service to which the variable payment relates.

The remaining transaction price is allocated as it otherwise would be under ASC 606 (i.e., allocated on a relative standalone selling price basis unless the discount exception applies [which is discussed in Section 8.3.1 of our revenue recognition guide]). Example 8-5 in our revenue recognition guide provides a detailed numerical example illustrating how to allocate the transaction price when the contract includes variable consideration.

7. Step 5: Recognizing revenue when (or as) each performance obligation is satisfied

Revenue is recognized when (or as) a performance obligation is satisfied, which is when control of the underlying good or service (i.e., an asset) is transferred to the customer. The amount of revenue recognized upon satisfaction of a performance obligation is the transaction price allocated to it.

To properly assess when revenue should be recognized, a technology entity must perform at contract inception an evaluation focused on whether a performance obligation is satisfied over time or at a point in time.

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Specific guidance, which is discussed in Chapter 8, is provided with respect to making this determination when the performance obligation consists solely of a license of IP (e.g., software). When accounting for a performance obligation that does not include a license of IP or that includes a license of IP combined with other goods or services, one or more of the following criteria must be met to conclude that the performance obligation is satisfied over time:

- *Customer simultaneously receives and consumes benefits as the technology entity performs.* A performance obligation is satisfied over time if the customer consumes the benefits of the technology entity's performance at the same time as the customer receives those benefits and the entity performs and creates those benefits. This criterion often applies to PCS or SaaS arrangements in which the entity receives the benefit of access to the software platform as the entity provides it.
- *Customer controls the asset as the entity creates or enhances the asset.* A performance obligation is satisfied over time if the customer controls the asset (which could be tangible or intangible) as it is created or enhanced by the technology entity's performance. In the technology industry, this could apply to a professional service contract in which an entity is engaged to make modifications within software owned by the customer.
- *No alternative use and an enforceable right to payment for performance to date.* A performance obligation is satisfied over time if the asset created by the technology entity's performance does not have an alternative use to the entity upon its completion and the technology entity's right to payment for its performance to date is enforceable. This criterion often applies to contracts for custom software development in which the entity is entitled to payment, including a reasonable margin, for the work performed throughout the contract term but does not transfer the software to the customer until it is complete.

If a performance obligation does not meet any of these three criteria, then it is considered satisfied at a point in time and revenue is recognized at the point in time the customer obtains control over the underlying good or service. In addition to determining whether a performance obligation is satisfied (and revenue is recognized) at a point in time or over time, ASC 606 also addresses the point in time that control of a good or service transfers to the customer and the manner or pattern in which control of a good or service transfers to a customer over time.

8. Licenses and rights to use IP

Licensing involves an entity (i.e., licensor) providing a customer (i.e., licensee) with a right to use its IP, which may come in many different shapes and sizes. Examples of IP that may be the subject of a license include software, trademarks, patents and copyrights. It is important to note that the entity still owns the IP subject to the license (i.e., ownership of the IP does not transfer to the customer).

The discussion in the remainder of this section focuses on how the following aspects of ASC 606 should be applied to contracts that include a license of IP: (a) identifying the performance obligations (i.e., units of account), (b) determining the transaction price when a contract includes a sales- or usage-based royalty and (c) determining when a performance obligation that includes a license of IP is satisfied (i.e., when does control of the IP transfer to the licensee).

8.1 Identifying the performance obligations in a contract that includes a license of IP

When a contract includes a license of IP and other promised goods or services, the entity must consider whether the license of IP is distinct from the other implicit or explicit promised goods or services in the related contract. For example, consider a contract that includes a software license and installation services. The software license and installation services are distinct if each is capable of being distinct and is distinct within the context of the contract.

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8.1.1 Capable of being distinct

If a customer can benefit from the software license on its own or by combining it with other resources readily available to the customer (e.g., installation services provided by a third party), the software license is capable of being distinct. If a customer can benefit from the installation services on their own or by combining them with resources readily available to the customer (e.g., the software license provided by the entity in the contract), the installation services are capable of being distinct.

8.1.2 Distinct within the context of the contract

If the software license and installation services are separately identifiable from each other, then each is distinct within the context of the contract. For this purpose, and to determine whether a promised good or service is distinct within the context of the contract, the entity must ascertain which of the following best describes its promise within the context of the specific contract:

- *The promise in the contract is to transfer the software license and installation services individually.* If this best describes the entity's promise within the context of the specific contract, the software license and installation services are distinct within the context of the contract.
- *The promise in the contract is to transfer installed software to which the software license and installation services are inputs.* If this best describes the entity's promise within the context of the specific contract, the software license and installation services are not distinct within the context of the contract.

Indicators are provided to assist in determining whether a promised good or service is distinct within the context of the contract. When the promised goods or services involved are a software license and installation services, those indicators are focused on whether the installation services significantly integrate, modify or customize the software and whether the software license is highly interdependent or highly interrelated with the installation services. Entities will need to exercise significant judgment when evaluating this criterion.

When the software license and installation services are not distinct, they are treated as a single performance obligation. Additional information about accounting for a single performance obligation that includes a software license and other promised goods or services is provided in Section 4.2.

When a contract includes a software license and updates, entities also will need to evaluate whether the updates are distinct from the license. In most cases, software will remain functional without the software updates, which leads to a conclusion that the customer can benefit from both the software and the updates either on their own or with other available resources. However, in some cases the software may not remain functional without the updates, which could lead an entity to conclude that the software is highly interdependent or interrelated with the updates. When assessing whether when-and-if-available updates are distinct from a software license, entities should consider the degree to which the software remains functional without the updates, as well as the frequency and method with which updates are made. For example, a five-year license for software that monitors compliance with frequently changing laws or regulations may lose its functionality without frequent updates. If such updates are made immediately upon the change of a law, pushed out to all software users and occur multiple times a month, that could indicate that the software and updates are not distinct.

ASC 606 provides an example in which the contract includes a three-year license to anti-virus software and when-and-if-available software updates during the three-year license term. While the software license and when-and-if-available updates are considered capable of being distinct, they are not considered distinct within the context of the contract. More specifically, the software license and when-and-if-available updates are not distinct within the context of the contract because the updates significantly modify the software's functionality so as to protect against new viruses and are integral to maintaining the software's utility over the three-year term. As a result, the entity concludes the software license and when-and-if-available updates are inputs to providing anti-virus protection. In other words, there is one

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performance obligation (i.e., unit of account), which includes both the software license and the when-and-if-available updates.

8.2 Determining the transaction price when a contract includes a sales- or usage-based royalty

The overall variable consideration guidance in ASC 606 should not be applied to a sales- or usage-based royalty when the only, or predominant, item to which the royalty relates is the license of IP, such as software. Royalties received related to a license of IP should not be included in the transaction price until the later of the resolution of the related uncertainty (i.e., sales or usage occur) or the satisfaction of the related performance obligation in whole or in part.

It should be noted that the point in time at which the entity receives sales data from its customers has no bearing on when the entity includes royalties related to those sales in the transaction price. If the entity does not yet have the sales data from its customer upon the later of those two events happening, it should estimate the royalties to which it expects to be entitled for purposes of including them in the transaction price at that point in time. This answer is consistent with the views expressed by SEC Deputy Chief Accountant Wesley Bricker in his remarks before the 35th Annual SEC and Financial Reporting Institute Conference in June 2016.

If there is a subsequent change in the entity's estimate of the royalties to which it expects to be entitled as a result of receiving the sales data from the customer, the entity should account for that change as it would account for any other change in the transaction price.

8.3 Determining when a performance obligation that includes a license of IP is satisfied

When the license of IP is distinct (i.e., its own performance obligation), the entity must determine whether the transaction price allocated to the license should be recognized over time or at a point in time. Specifically with respect to a software license, because software has significant standalone functionality, it typically is considered a right to use the IP and the allocated transaction price is recognized at the point in time that control of the right to use the software transfers to the customer.

A software license would not be considered a right to use IP (i.e., it would be considered a right to access IP for which the allocated transaction price is recognized over time) only when the following two criteria are met:

- Substantive changes to the functionality of the IP are expected to result during the license period from activities of the entity that do not transfer a promised good or service to the customer
- The customer must use (either contractually or practically) the substantively changed IP

If both of these criteria are met, what would otherwise be considered a right to use the IP would be considered a right to access the IP. The FASB indicated in paragraph BC58 of ASU 2016-10 that it would expect both of these criteria to be met "only infrequently."

When the license of IP is not distinct, it is combined with other promised goods or services in the contract until a performance obligation exists. The entity then applies the overall approach to recognizing revenue, which requires consideration of whether the performance obligation is satisfied at a point in time or over time (see Chapter 7) and, if it is the latter, the method that should be used to measure progress toward the complete satisfaction of the performance obligation.

Prior to recognizing revenue related to a license of IP (whether over time or at a point in time), a copy of the IP must have been provided or otherwise made available to the customer and the period over which the customer is able to use and benefit from its rights to the IP must have started (i.e., the license period has begun). The need to meet the second of these criteria before revenue is recognized results in

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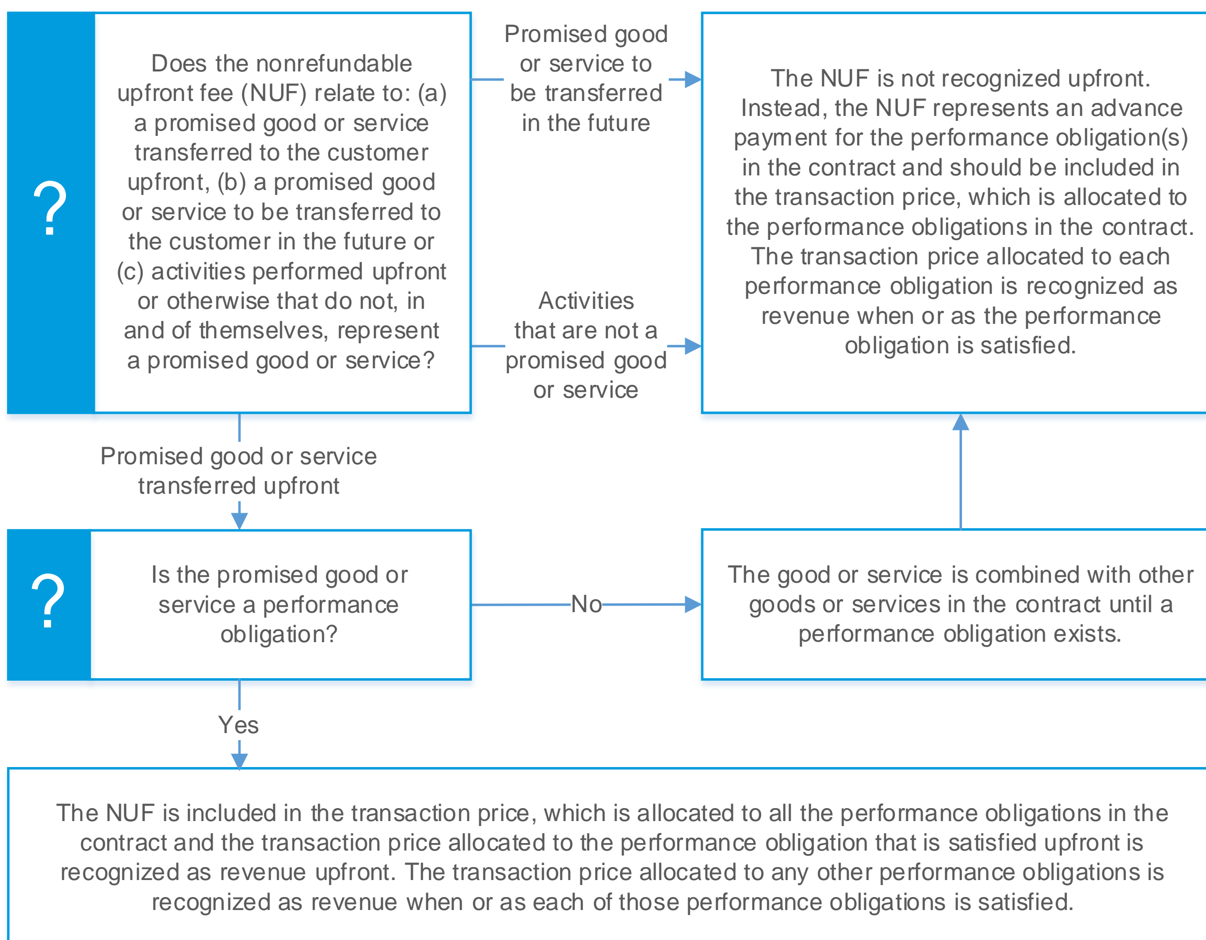
revenue related to a license renewal being recognized no earlier than the beginning of the renewal period.

9. Accounting for certain nonrefundable upfront fees

Contracts entered into by entities in the technology industry may require the customer to pay a nonrefundable upfront fee. For example, a SaaS customer may be required to pay a setup fee at the beginning of a three-year contract, in addition to monthly payments to access the hosted software.

As discussed in Chapter 10, costs incurred by the entity to perform activities that do not represent a performance obligation (e.g., setup activities related to providing hosted software) may need to be capitalized and amortized. However, if applying the guidance in ASC 606 results in recognizing revenue for a nonrefundable upfront fee over time, the period over which that fee is recognized may not be the same as the period over which any costs capitalized under ASC 340-40 are amortized.

In general, a nonrefundable upfront fee is only recognized as revenue upfront if it relates to a good or service that is a performance obligation and is satisfied upfront. The facts and circumstances that are necessary for that accounting result, as well as the other potential accounting results for nonrefundable upfront fees, are illustrated in the flowchart:



As explained in the flowchart, the timing of when a nonrefundable upfront fee should be recognized (whether upfront or otherwise) depends on the nature of the performance obligations in the contract. If

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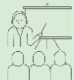
one of those performance obligations is a contract renewal option that provides the customer with a material right, the period over which the upfront nonrefundable fee is recognized could extend beyond the contract term as determined for purposes of applying ASC 606. In addition, the presence of a nonrefundable upfront fee can, in certain circumstances, lead to a conclusion that a contract renewal option provides the customer with a material right that it would not have received without entering into the contract with the customer. Consider the following examples.



Example 9-1: Determining whether a nonrefundable upfront fee relates to promised goods and services or setup activities

Company A enters into a SaaS contract with Customer B to provide access to its software platform over a five-year period. Before providing the services, Company A must setup Customer B on its systems, which involves building an interface between its systems and Customer B's systems and testing that interface; migrating and testing Customer B's data; and building and testing a portal that Customer B will use to easily access information about the transactions processed and resolve any errors identified in the process. Company A is entitled to a nonrefundable upfront fee of $1 million as compensation for the costs it will incur performing the setup activities and annual transaction processing fees of $3 million.

Building and testing the interface and portal and migrating and testing data are activities Company A performs to enable it to provide access to the software platform to Customer B. These setup activities do not provide any benefit to Customer B absent Company A providing access to the platform. As a result, the setup activities do not provide Customer B with a promised good or service, which also means they cannot be a performance obligation. This conclusion is unaffected by the presence of a $1 million nonrefundable upfront fee meant to compensate Company A for the performance of the setup activities. In other words, setup activities do not represent a promised good or service even if a customer pays a nonrefundable upfront fee to compensate the entity for performing those activities.

Example 9-2: Accounting for a nonrefundable upfront activation fee and a contract renewal right (Question 52 of FASB's Revenue Recognition Implementation Q&As)

Entity charges a $50 one-time activation fee and agrees to provide Customer with services on a month-to-month basis at a price of $100 per month. Customer is under no obligation to continue to purchase the monthly service and Entity has not committed to any pricing levels for the service in future months. Because the activity of signing up Customer for service does not result in the transfer of a good or service, it does not represent an additional promised service. Rather, the activation fee is an advance payment for Entity's services and should, therefore, be deferred and recognized as the future service is provided. Entity's average customer life is two years.

RSM COMMENTARY: This example was discussed by the FASB staff and a summary of the discussions is provided in Question 52 of the FASB's Revenue Recognition Implementation Q&As. The FASB staff and TRG concluded that the period of time over which the nonrefundable activation fee should be recognized depends on whether it provides the customer with a material right:

- *Payment of the nonrefundable activation fee provides the customer with a material right related to contract renewal.* The activation fee should be recognized over the period the customer is expected to benefit from paying the activation fee. The period over which the customer is expected to benefit from paying the activation fee may not necessarily be the two-year average customer life. The entity should take various qualitative and quantitative factors into consideration in identifying the period of time the customer is expected to

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benefit from paying the activation fee, which are similar to the factors considered in determining whether the nonrefundable activation fee provides the customer with a material right (see discussion of some of those factors later in this commentary).

- *Payment of the nonrefundable activation fee does not provide the customer with a material right related to contract renewal.* The activation fee should be included in the transaction price for the contract and recognized as revenue as the services the entity is obligated to provide under the contract are transferred to the customer. As a result, the transaction price of $150 ($100 monthly fee for the one-month contract term and $50 activation fee) should be recognized over the one-month contract term.

To determine whether the nonrefundable activation fee provides the customer with a material right, an entity should consider the guidance on determining whether an option to purchase additional goods or services represents a material right, which is discussed in Section 4.3 of this whitepaper and Section 6.6.2 of our revenue recognition guide. Based on that guidance, the FASB staff provided a number of factors the entity should consider, including the following:

- Does the renewal price of $100 per month the customer would pay provide it with a material right compared to the $150 ($50 activation fee and $100 monthly fee) a new customer would pay for the same service?
- Could the customer obtain equivalent services from another service provider, and if so, how does what the customer would pay the other service provider compare to what it would pay the entity? For example, does the other service provider charge an activation fee that is nonrefundable and, if so, in what amount?
- How does the average customer life compare to the one-month contract period? For example, is the average customer life significantly longer than the contract period because customers are incentivized to continue to purchase services from the entity so that they do not have to pay another activation fee?

When the entity concludes that paying the nonrefundable activation fee provides the customer with a material right, considering these factors also may assist in identifying the period over which the customer expects to benefit from paying that fee.

Determining whether the payment of an upfront nonrefundable fee represents a material right will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

10. Contract costs

10.1 Scope

ASC 340-40 addresses the circumstances under which certain costs that arise in conjunction with performing under contracts within the scope of ASC 606 should be capitalized. The two categories of costs addressed in ASC 340-40 include costs to fulfill a contract and costs to obtain a contract.

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10.2 Costs to fulfill a contract

If there is other guidance in the ASC that applies to the costs incurred to fulfill a contract within the scope of ASC 606, that other guidance should be applied. Examples of other guidance on how to account for costs that may be involved in the fulfillment of a contract include:

ASC	Type of fulfillment cost
330	Inventory
340-10-25-1 to 25-4	Preproduction costs related to long-term supply contracts
350-40	Costs of internal-use software
360	Costs related to property, plant and equipment
720-35-25-1A	Certain advertising expenditures incurred after revenue is recognized (e.g., cooperative advertising)
946-720-25-3	Offering costs of advisors of both public and private funds
985-20	Costs of software to be sold, leased or marketed

Note 1: Prior to applying the guidance noted, it is important to understand the specific scope provisions of the guidance to ensure it is applicable to an entity and the specific cost being evaluated.

If the guidance in the table, or other specific guidance, is applicable to a fulfillment cost incurred by the entity, it must be applied. ASC 340-40 is only applicable to costs to fulfill a contract when there is no other applicable guidance.

If certain criteria are met, fulfillment costs within the scope of ASC 340-40 must be capitalized. A technology entity may not choose to expense such costs when the criteria are met.

10.3 Costs to obtain a contract

It is not uncommon for certain entities in the technology industry, such as those that provide SaaS or hosting services, to pay an employee a commission for signing a customer to a long-term contract. The incremental costs to obtain a specific contract within the scope of ASC 606 are those costs that would not have been incurred if the contract was not obtained, such as a sales commission. For a cost to be considered an incremental cost of obtaining a contract, the technology entity must be obligated to make a payment only as a result of entering into the contract. The incremental costs to obtain a contract should be capitalized if the technology entity expects to recover those costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). However, a technology entity may elect a practical expedient that allows it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less. Care should be taken when evaluating the period over which costs to obtain a contract should be amortized, as it may not be equivalent to the original contract term. When a commission is only paid upon the entity initially obtaining the contract (i.e., no commission is paid upon contract renewals), the capitalized commission cost relates to both the initial contract and any expected contract renewals. Similarly, when the commission paid on renewals is not commensurate with the commission paid on the original contract, entities should consider expected renewals when determining the amortization period.

Costs to obtain a contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the contract that would have been incurred even if the contract was not obtained (e.g., travel costs incurred to present a proposal to the customer). These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the technology entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

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10.4 Amortization and impairment of capitalized costs

ASC 340-40 provides guidance on amortizing costs capitalized in accordance with its provisions, as well as testing those capitalized costs for impairment. This guidance is summarized and illustrated in Section 13.3 and Section 13.4 in our revenue recognition guide.

11. Disclosures

Many qualitative and quantitative disclosure requirements are included in ASC 606-10-50 and ASC 340-40-50. ASC 606-10-50-1 states the following as the overall disclosure objective of ASC 606 (which is also the overall disclosure objective of ASC 340-40): "The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."

The disclosures required to achieve this objective focus on providing a variety of revenue-related information. Some of the information that must be disclosed is high-level, such as the amount of revenue recognized from customer contracts and the amount of any impairment (or credit) losses recognized on receivables or contract assets related to customer contracts. However, there is also a significant amount of detailed information that must be disclosed annually related to customer contracts, including information about:

- Disaggregated revenue
- Contract assets, contract liabilities and receivables
- Performance obligations
- Transaction price allocated to remaining performance obligations at the end of the reporting period (disclosures required for public entities and elective for nonpublic entities)
- Significant judgments about the timing of satisfying performance obligations
- Significant judgments about the transaction price and the amounts allocated to performance obligations
- Practical expedients (disclosures required for public entities and elective for nonpublic entities)
- Capitalized costs related to obtaining or fulfilling a customer contract (disclosures required for public entities and elective for nonpublic entities)

The nature and extent of the required disclosures in each of the preceding categories depends on whether the entity is a public entity (more required disclosures) or nonpublic entity (fewer required disclosures). In addition, while more disclosures are required for annual periods, some disclosures also are required for interim periods. However, when a technology entity applies ASC 606 and 340-40 in its interim financial statements for one or more interim periods before it applies ASC 606 and 340-40 in its annual financial statements, the entity must provide all the required annual disclosures in those interim financial statements.

Detailed discussion and illustrations of the disclosure requirements for both public and nonpublic entities are included in Chapter 15 of our revenue recognition guide.

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