
# REVENUE RECOGNITION IN THE TECHNOLOGY INDUSTRY

**August 2026**

**This publication provides an in-depth discussion of the application of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, to arrangements commonly encountered in the technology industry. While the core revenue recognition framework applies broadly across industries, technology entities often face heightened complexity due to multiple element arrangements, software and intellectual property licenses, software-as-a-service (SaaS) models, contract modifications, variable consideration, and evolving customer options. This paper highlights areas of the revenue guidance that require significant judgment with the objective of supporting consistent and well-reasoned application of the guidance.**

**This publication is intended for preparers, auditors and other financial reporting professionals involved in accounting for revenue arrangements in the technology sector. It is designed to supplement the authoritative guidance in ASC 606 and ASC 340-40 and to be read in conjunction with broader revenue recognition interpretive guidance. Given the significant judgment involved in many of the areas discussed, entities should carefully evaluate their specific facts and circumstances to ensure that conclusions are supported by robust documentation and appropriate disclosures.**

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# 1. Background

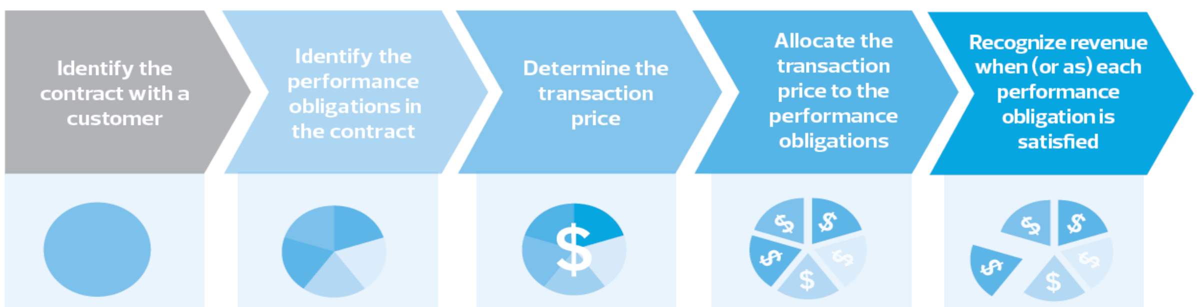
In 2014, the FASB issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606),* to provide a robust framework and comprehensive principles for addressing revenue recognition accounting. Additionally, the guidance on accounting for certain costs related to a contract 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 publication highlights aspects of the guidance that are particularly pertinent for these entities. For additional information about all revenue recognition guidance, including those aspects discussed in this publication, as well as numerous examples illustrating how to apply the guidance, refer to our guide, *A guide to revenue recognition*.

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 *Revenue Recognition: Audit and Accounting Guide* (Revenue Recognition AAG), a comprehensive nonauthoritative revenue recognition guide 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 publication 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

ASC 606 is applicable for contracts with customers that do not meet any of the scope exceptions in ASC 606-10-15-2. The ASC Master Glossary defines a contract as "[a]n agreement between two or more parties that creates enforceable rights and obligations" and a customer as "[a] party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." To account for a contract with a customer in accordance with the general model in the guidance, the following 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
- 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 these contract criteria are met, the remaining steps in the five-step revenue recognition model are applied to the contract. When all of these contract criteria are not met, revenue is deferred and the contract criteria continue to be evaluated to determine whether they are subsequently met. Absent meeting these contract criteria, revenue is only recognized under very limited circumstances, which could result in the deferral of revenue for what may be a significant period of time, even if nonrefundable cash has been received and the entity has transferred some of the promised goods or services in the contract to the customer.

Entities should focus on whether a contract exists, whether the contract is with a customer and whether the contract criteria are met. ASC 606-10-25-2 states, “Contracts can be written, oral, or implied by an entity’s customary business practices,” so the lack of a signed contract does not affect the recognition of revenue if there are enforceable rights and obligations and the contract criteria have 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 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 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 the consideration when due 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.** The amount of consideration may not equal the price stated in the contract. 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, with the expectation and customary business practice of accepting less than the contractual amount of consideration in exchange for the goods or services. As a result, the transaction price could be less than the contractually stated price.
- **Mitigating credit risk.** An entity should consider the extent of its ability to mitigate credit risk related to the transaction price. For example, an entity may have the ability and intent to stop transferring goods or services to the customer if the customer does not pay for goods or services already transferred to the customer. 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).
- **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 criteria continue to be evaluated to determine whether they are subsequently met. Absent meeting the contract existence criteria, revenue is only 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 criteria have been met, the remaining four steps would be applied to the contract for purposes of recognizing revenue. If a receivable or a contract asset is recognized as a result of applying ASC 606 to the contract, the recognition of any related credit losses would be accounted for under ASC 326-20 as an allowance for credit losses and credit loss expense (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, the accounting is based on an analysis of whether the remaining goods or services to be transferred based on the modified contract are distinct from the goods or services that were transferred on or before the modification date:

- **Remaining goods or services are distinct.** Account for the contract modification as the termination of one contract and execution of a new contract (i.e., prospectively).

- **Remaining goods or services are not distinct.** Account for the contract modification as if it were part of the existing contract, which could result in recognition of an increase in or a reduction of revenue as a cumulative catch-up adjustment.
- **Some, but not all goods or services are distinct.** Account for the effects of the contract modification in a manner that is consistent with the contract modification objective in ASC 606-10-25-13.

# 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 as each of those obligations is fulfilled.

Contracts in the technology industry often include multiple promised goods or services. For example, a contract may include hardware, installation, software licenses (term or perpetual), PCS, specified 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 a promised good or service is a distinct performance obligation that is accounted for separately or if it should be combined with one or more other promised goods or services and accounted for as a combined performance obligation. 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, taking care not to inappropriately combine individual promised goods or services in this step. 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 promised good or service. 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 promised good or service in a contract, consideration must be given to whether the promised 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 guide, *A guide to revenue recognition*.

Licenses are a common performance obligation in the technology industry. Licensing involves an entity (i.e., licensor) providing a customer (i.e., licensee) with a right to use its intellectual property (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).

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.

#### 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.

#### 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 guide, *A guide to revenue recognition*) 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.

### 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 IP and is accounted for under the general guidance in ASC 606.

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).

### 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. For smart devices with embedded technology, a technology entity should consider the guidance in ASC 606-10-55 through 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 or 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 a significant integration service?
- 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 smart device retain substantive functionality if the customer does not use, renew or maintain access to the cloud-based service?
- Does the technology entity have a history of selling the smart device without the associated services?
- Can the customer obtain substantially similar cloud-based services, maintenance or support from another party, or are those services available only from the technology entity?
- What is the customer's intended benefit from the arrangement, and does obtaining that intended benefit depend on the entity transferring both the smart device and the cloud-based subscription together?

In her remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments, SEC staff member Sheri York discussed a fact pattern involving a smart device sold with an embedded software license, a cloud-based service and technical support, noting that the analysis should not stop at whether each item is capable of being distinct. Rather, entities should evaluate the nature of the promise to the customer in the context of the contract to determine whether the device, embedded software and cloud-based service are separately identifiable or instead function together as inputs to a combined output with functionality or utility that is different from the functionality or utility provided by the goods and services independently. For example, if the device has only limited utility without the cloud-based service, the software primarily enables connectivity to that service and the entity's ongoing activities are necessary for the customer to receive the intended functionality, those facts may indicate that the arrangement includes a single combined performance obligation rather than separate performance obligations for the device, software and services. Conversely, if the customer can use the device for its intended purpose without the ongoing service, the services do not significantly modify or customize the device or embedded software, and the entity is not providing a significant integration service, identification of each good or service as a separate performance obligation may be appropriate.

#### 4.2.5 Additional considerations when selling software with updates and customer support

Technology companies frequently sell software with PCS, including software updates and support, and must assess whether the software license is distinct from the updates (and therefore, revenue is allocated to the license as a separate performance obligation and recognized separately) or the software license is not distinct from the updates and should be combined with the updates into a single performance obligation (which would be recognized over the PCS period). Customer support is generally distinct, but it may be combined with the updates and treated as a single performance obligation if the updates are provided over the same period.

In most cases, software will retain baseline functionality without the software updates, which leads to a conclusion that the software is capable of being distinct because 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 maintain its intended utility without the updates, which could lead an entity to conclude that the software is highly interdependent or interrelated with the updates and therefore not distinct in the context of the contract.

When assessing whether updates should be combined with a software license, licenses should be identified as a separate performance obligation unless the updates in the PCS are expected to significantly modify the software or are critical to maintaining the ongoing utility of the software.

Factors indicating that the software and updates should be combined into one performance obligation include:

- Providing updates is central to fulfilling the promise in the contract and the intended purpose of the software
- The updates are critical to the core functionality of the software and the utility of the software declines quickly and significantly without the updates

- The updates are related to changes caused by external factors outside the entity’s control that impact the software's ability to function as intended
- The entity has more than insignificant resources dedicated to monitoring those external factors, identifying the need for updates, and developing and releasing the necessary updates
- The updates are expected to be frequent relative to the contract term
- Customers download or accept updates when they are made available
- The customer cannot practically obtain the updates from another source

While these indicators are not all inclusive, we understand these are the primary indicators the SEC staff has shared regarding the determination of whether software and updates should be combined. While not all indicators need to exist to combine the software and updates, we believe that many of these indicators generally should be present to support treating them as a single performance obligation.

**Example 4-1: Anti-virus software not distinct from updates (ASC 606-10-55-140D through ASC 606-10-55-140F)**

An entity grants a customer a three-year term license to anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The entity frequently provides updates that are critical to the continued utility of the software. Without the updates, the customer's ability to benefit from the software would decline significantly during the three-year arrangement.

The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer), while the customer can benefit from the updates together with the software license transferred at the outset of the contract.

The entity concludes that its promises to transfer the software license and to provide the updates, when-and-if available, are not separately identifiable (in accordance with paragraph 606-10-25-19(b)) because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The updates significantly modify the functionality of the software (that is, they permit the software to protect the customer from a significant number of additional viruses that the software did not protect against previously) and are integral to maintaining the utility of the software license to the customer. Consequently, the license and updates fulfill a single promise to the customer in the contract (a promise to provide protection from computer viruses for three years). Therefore, in this Example, the entity accounts for the software license and the when-and-if available updates as a single performance obligation. In accordance with paragraph 606-10-25-33, the entity concludes that the nature of the combined good or service it promised to transfer to the customer in this Example is computer virus protection for three years. The entity considers the nature of the combined good or service (that is, to provide anti-virus protection for three years) in determining whether the performance obligation is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and in determining the appropriate method for measuring progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37.

**RSM COMMENTARY:** When considering the conclusions reached in this example in light of the factors above, the following is noted:

- The promise to the customer is to detect, prevent and provide safeguards from viruses. Given the rapidly evolving nature of computer viruses and the risk of not detecting or preventing a new virus, providing updates is central to fulfilling the promise in the contract and the intended purpose of the software.

- The utility of the software requires that it provide protection against all virus threats; therefore, updates are critical to the core functionality of the software and the utility of the software declines quickly and significantly without the updates.
- The updates are related to changes caused by external factors outside the entity's control (i.e., new viruses being created by external parties).
- The entity must proactively and continuously monitor for new viruses and devote resources to developing and updating the software to protect against them.
- The updates are expected to be frequent relative to the contract term, as a typical anti-virus software would update daily.
- Evidence supports that customers generally download or accept updates to anti-virus software when they are made available.
- The customer cannot practically obtain the updates from another source.

**Example 4-2: International customs compliance software including updates**

An entity grants a customer a three-year term license to software designed to manage compliance with international customs laws. The software assists in correctly classifying goods to meet regulatory requirements, calculates taxes and tariffs, and provides real-time legislation updates to ensure international compliance across over 150 countries. Without the updates, the customer's ability to benefit from the software would decline significantly during the three-year arrangement, as they would not be able to calculate taxes and tariffs correctly or submit current versions of the relevant forms and could be subject to fines or delays in importing and exporting goods due to these errors.

The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer), while the customer can benefit from the updates together with the software license transferred at the outset of the contract.

The entity concludes that its promises to transfer the software license and to provide the when-and-if available updates are not separately identifiable (in accordance with paragraph 606-10-25-19(b)) because the license and the updates are, in effect, inputs to a combined item (software that facilitates international customs compliance) in the contract. The promise to the customer is to provide software that facilitates compliance with international customs regulations, and providing updates is central to fulfilling the promise in the contract and the intended purpose of the software. The entity considers the following factors:

- The utility of the software requires that it incorporate current legislation, tariff or tax rates, and forms in order for the customer to maintain compliance with international regulations; therefore, updates are critical to the core functionality of the software and the utility of the software declines quickly and significantly without the updates.
- The updates are related to changes caused by external factors outside the entity's control (e.g., changes in legislation, rates or forms made by government agencies).

- The entity must proactively and continuously monitor for changes in legislation, rates and forms and devote resources to developing and updating the software to comply with them.
- The updates are expected to be frequent relative to the contract term, with multiple updates being pushed out every month.
- Evidence supports that customers generally download or accept updates to the software when they are made available.
- The customer cannot practically obtain the updates from another source.

Because the license and updates fulfill a single promise to the customer in the contract (a promise to provide software to facilitate compliance with current international customs regulations), the entity accounts for the software license and the when-and-if available updates as a single performance obligation. See Example 7-1 for a discussion of when and how revenue would be recognized in this example.

### 4.2.6 Additional considerations when selling software with professional services

Similar to the analysis of whether software is distinct from related updates and customer support as described in Section 4.2.5, judgment is also required in determining if other promised goods or services, such as professional services, should be combined with a software license into a single performance obligation. 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 professional services (e.g., 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 professional services are capable of being distinct.

As described in Section 4.2.2, ASC 606 provides indicators 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 professional services, the analysis of those indicators would focus on whether the entity performs a significant integration service to integrate the software with professional services, whether the entity modifies or customizes the software, or whether the software license is highly interdependent or highly interrelated with the professional services. Entities will need to exercise significant judgment when evaluating this criterion.

When the software license and professional services are not distinct, they are treated as a single performance obligation.

The complexity of professional services can vary, with higher complexity professional services related to the software, such as complex implementation services, more likely to result in combining the professional services with the software license into a single performance obligation whereas lower complexity professional services often result in a conclusion that there are separate performance obligations. Some types of professional services that require significant judgment include:

- **Configuration services.** Configuration involves adjusting settings and parameters within the existing software without modifying its code, tailoring functionality to specific needs.
- **Implementation services.** Implementation services cover software selection, requirement definition, planning, installation, integration, testing and post-deployment review. These services can be provided by vendors, alternative providers or in-house staff, with complexity determining who can perform them. Some sophisticated providers can handle complex implementations requiring code access.

- **Customization services.** Customization involves modifying or adding code to create new or enhanced features for the software.

Because of the nature of configuration services, these will generally be separate performance obligations, as they do not modify or customize the underlying software coding. In general, we believe the limited circumstances in which configuration services are not distinct from the software (i.e., the software and configuration services would not be a single combined performance obligation) are when both:

- The configuration services are required in order for the customer to obtain the intended utility of the software
- No other entity (including the customer) can perform the configuration as the services require proprietary knowledge of or access to the underlying software code.

As part of the evaluation of whether implementation or customization services are distinct from the software, understanding the IT environment is crucial. For example, if an entity never sells core software on its own and the customer cannot use or benefit from the software without professional services that require changing and building on the core software code which no other entity would be legally able to provide, the professional services are not capable of being distinct and would be combined with the software and accounted for as a single performance obligation.

If, however, the professional services involve writing new code that interacts with an entity's core software, essentially creating a "bridge" software that doesn't change the underlying code but allows the entity's software to interact with the customer's software, it will generally be considered capable of being distinct. This is because another third party could hypothetically provide the professional coding services without obtaining rights to the underlying intellectual property of the core software.

In performing this assessment, it is important that the entity carefully assess the nature of the individual promised goods or services in the contract, since this assessment can have a significant impact on both the identification of distinct performance obligations and the timing of revenue recognition in Step 5 (see Section 7.2).  For example, to continue with the fact pattern where an entity creates "bridge" software, the entity should consider the nature of the bridge software and whether the code will be owned by the entity or the customer when determining the nature of the promise to the customer. If the newly developed software code is owned by the customer, housed on the customer's network and cannot be used by other customers, then the promise to the customer is to develop the customer's underlying IP. Therefore, the customer controls the asset as it's created, leading to over-time recognition as the IP is created under Step 5. If, on the other hand, the rights to the newly developed software code remain with the entity and can be used to connect other customers with similar software, the promise will generally be a license to use the underlying IP, and control will not transfer until the license period for the bridge software begins.

If it is determined that the software and professional services are capable of being distinct, a second evaluation must be done to conclude whether they are distinct in the context of the contract. When evaluating these types of services, the fundamental question that must generally be considered is whether the customer is buying a software license with supporting services (i.e., separate performance obligations) or a complex integration or highly customized software solution tailored for the customer's specific needs and environment (i.e., a combined performance obligation).

Consistent with ASC 606-10-25-21, when making this determination, entities should consider whether the following indicators are present, which may suggest combining the services with the software license into a single performance obligation is appropriate:

- The entity is providing a significant integration service (using its expertise to create a combined output using the promised goods or services as inputs).
- One good or service significantly modifies or customizes the other or the goods or services are significantly modified or customized by each other.

- The goods or services are highly dependent on, or highly interrelated with, each other.

In practice, licenses and professional services are most often considered separate performance obligations. Specific indicators that the software and the services should be combined include:

- Significant and regular two-way interaction between software and other services
- Inseparable risk between the software license and implementation (often evidenced by onerous customer acceptance clauses)
- Essential interaction for intended customer benefit (e.g., customer would not enter into the license agreement without the associated services because it could not obtain the intended benefit of the software without the services)
- Transformative, rather than merely additive, functionality resulting from the combination of the software and services (i.e., rather than a one-way handoff involving installation of off-the-shelf software, new software code may change the software's intended utility for the specific customer)

Additional factors that may be relevant when performing this assessment include, but are not limited to, whether the customized solution is unavailable elsewhere, whether the software license is rarely sold separately, and whether there is an extended implementation period or significant cost to the professional services.

**Example 4-3: Software contract with customization services**

Company A entered into a contract with Customer B for a perpetual software license and customization services.

As part of the customization services, the software will be substantially modified to add significant new functionality. Without these features and functionality, the customer would not have purchased Company A's baseline software license and would not be able to obtain the intended benefit from the licensed software.

Company A concludes that the software and customization services should be accounted for as a single performance obligation. The software license and customization services are not considered distinct within the context of the contract, as the customization services significantly modify the software, such that the software and customization services are inputs to produce a combined output. See Example 7-2 for a discussion of the timing of revenue recognition in this example.

**Example 4-4: Software contract with implementation services**

Company A entered into a contract with Customer B for an on-premise software license with a three-year term and implementation services.

The implementation services are required to allow the software to interface with Customer B's existing systems. The customer cannot benefit from the base software without the implementation services, which allow the software to function in the customer's IT environment.

**Scenario 1**

The implementation must be performed by Company A as the process involves changing underlying software code, which is the intellectual property of Company A.

Company A concludes that while the software and implementation services are capable of being distinct, because the Company does sell the base software on its own, the software and implementation services are not distinct in the context of the contract as the customer cannot obtain the intended benefit of the software without the implementation services, which cannot be performed by any other entity and therefore accounts for the software and implementation as a single performance obligation. See Example 7-3 for a discussion of the timing of revenue recognition in this example.

**Scenario 2**

Assume the implementation involves new software code to create a bridge that will allow Customer B's IT system to interface with Company A's software but does not change the underlying code of the original software product and does not create combined functionality (e.g., functionality that is dependent on both the licensed software and software within Customer B's existing IT system). Customer B will also obtain a license for the bridge software, which is not expected to require significant ongoing updates after initial implementation. No other companies provide this service, but a hypothetical third party with the appropriate expertise but no proprietary knowledge of the software source code would be able to create this bridge.

Because Company A sells the software on its own, both the software and the implementation services are capable of being distinct, even if Company A never sells implementation services alone. This is because the definition of a readily available resource in ASC 606-10-25-20 includes "a good or service that is sold separately (by the entity or another entity)." In other words, the software is capable of being distinct because Company A sells it separately, and the implementation services are capable of being distinct because Customer B could benefit from the implementation services in conjunction with the software, which is a "readily available resource" because Company A sells it separately.  Furthermore, a readily available resource also includes "a resource that the customer has already obtained from the entity" so even if Company A does not sell the license separately and only sells it together with implementation services, a license transferred to Customer B prior to providing implementation services would be considered a "readily available resource" with which the customer can benefit from the implementation services.

Finally, while the implementation is required for Customer B to use the software within its IT system, it does not change the overall functionality of the software such that the implementation and the software are inputs into a combined output. Company A considers the indicators of when a promised good or service is not distinct in the context of the contract and determined that:

- The technology entity is not providing a significant service of integrating implementation with the software, with the result being that the two are inputs that are transformed into a single combined output.
- The promised goods or services do not significantly modify or customize one another as the overall functionality and purpose of the software is not altered as a result of the implementation.
- The promised goods or services are not highly interdependent or highly interrelated with one another as the services do not significantly affect the utility of the license.

The implementation and software are therefore distinct within the context of the contract and Company A concludes that the software and implementation are separate performance obligations. See Example 7-4 for a discussion of the timing of revenue recognition in this example.

## 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.

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 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 8.

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 discusses certain 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. Actions taken by the customer obligate the technology entity to provide additional promised goods or services (e.g., additional licenses or seats). | The technology entity is obligated to provide the promised goods or services without the customer exercising an incremental right. Actions taken by the customer (e.g., entity transfers a single software license and usage of the software triggers usage-based fees) resolve the uncertainty related to the amount of consideration it is obligated to pay |
| The customer becomes obligated to transfer additional consideration to the technology entity only after it exercises its right to purchase additional promised goods or services. | The customer becomes obligated to transfer additional consideration to the technology entity after or as it obtains control of the promised goods or services transferred by the technology entity. |

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 could be affected (unless the entity is eligible for and elects an available practical expedient).

**Example 4-5: 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 Transition Resource Group for Revenue Recognition (TRG) concluded the each of the following two examples include a series of distinct services that represent a single performance obligation (see Section 6.3 of our guide, *A guide to revenue recognition*) with 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 facts that led to the FASB staff's conclusions that a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (i.e., a single performance obligation) exists in each example. If different conclusions were reached about the nature and number of performance obligations 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 guide, *A guide to revenue recognition.*

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). Chapter 8 discusses the accounting for nonrefundable upfront fees.

### 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 FASB staff and 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 4-6: 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 how pricing compared to competitors. Chapter 8 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 underlying goods or services are not performance obligations in the initial contract. 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 guide, *A guide to revenue recognition*). 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 this customer only because it is entering into the current contract. This is important to keep in mind because the effects of the customer getting only 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, as a practical alternative to estimating the standalone selling price of the option, 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.

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

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

When another party is involved with the technology entity in providing a promised good or service to the customer, principal versus agent guidance must be applied. A principal recognizes revenue on a gross basis, while an agent recognizes the net amount to which it is entitled for performing an agency service (e.g., facilitating the transaction between the principal and the end customer) as revenue. For example, technology entities often sell products or services through a reseller. The reseller of technology products or services should evaluate whether it is the principal or agent based on whether it obtains control of a good or service from the technology entity before transferring control to an end user.

While principal versus agent guidance addresses whether a reseller or other intermediary is a principal or agent, the guidance is also relevant to the identification of a technology entity's customer when a reseller or other intermediary is involved. For example, a technology entity selling through a reseller should consider whether the reseller is the principal or agent to determine whether the technology entity's customer is the reseller (i.e., the technology entity transfers control of a good or service to the reseller) or the end user (i.e., the technology entity transfers control of a good or service to the end user, with the reseller acting as an agent to facilitate the transfer).

There are two key steps in the principal versus agent guidance:

1. Identifying the specified goods or services being provided to the customer (i.e., identifying the unit of account for the principal versus agent analysis by determining whether the goods or services promised to the end customer are distinct)
2. Determining whether the entity obtains control of the specified goods or services before transferring control of those goods or services to the customer

When another party is involved with the entity in providing the promised goods or services that make up a distinct specified good or service to the end customer, an entity is a principal with respect to providing the specified good or service to the end customer in the following situations:

- The entity obtains control of a good from the other party and then transfers that good to the end customer.
- The entity obtains control of a right to a service from the other party and has the ability to direct the other party in providing the service to the end customer on the entity's behalf.

- The entity obtains control of a good or service (e.g., inputs) from the other party that the entity then combines with other goods or services to provide the specified good or service (e.g., outputs) to the end customer.
- The entity is the provider of the good or service and the other party does not obtain control of the good or service but rather facilitates the transfer of control of the good or service from the entity to the end customer.

Many resellers of software, PCS or SaaS provide additional promised goods and services, such as implementation, configuration and integration services. Therefore, an important part of the analysis is identifying the specified goods or services received by the end customer. This is done using the same guidance used to identify whether promises are distinct and therefore separate performance obligations (see Section 4.2). For example, when assessing whether the reseller provides a significant integration service that combines the software, PCS or SaaS with other goods or services, the SEC staff has noted that if an entity does not control the promised goods or services from a third party, it would generally not be able to significantly integrate those promised goods or services with its own offering.

The specified service for a SaaS reseller when it performs the principal versus agent analysis is typically the vendor's SaaS. Accordingly, a reseller should consider whether it obtains a right to direct the vendor to provide SaaS before the SaaS is provided to an end customer. A reseller may conclude that it does not control the SaaS for a variety of reasons, including that it does not provide the SaaS itself, it cannot direct the vendor to change or modify how it provides SaaS, or it is not primarily responsible to the customer for SaaS performance (e.g., it lacks supplier discretion and cannot fulfill the promise to the customer by using another SaaS provider).

In some cases, an analysis of the facts and circumstances will conclusively show that the reseller or other intermediary obtains control over the specified good or service (i.e., it has the ability to direct the use of the specified good or service and receive substantially all of the related remaining benefits) and is therefore a principal. In other situations, judgment may be required to determine whether the entity obtains control over the specified good or service, in which case the entity should consider the following indicators:

- **Primary responsibility for fulfillment.** If the reseller or other intermediary (and not the supplier) is primarily responsible to the customer for fulfillment of the specified good or service, then that supports the reseller or other intermediary obtaining control of the specified good or service before it is transferred to the customer. Having primary responsibility for fulfillment typically involves being responsible for the acceptability of the specified good or service (e.g., being responsible for the specified good or service meeting customer specifications). If the reseller or other intermediary is nominally responsible to the customer for the specified good or service's acceptability but is eligible for reimbursement from the supplier for any compensation given to the customer, this may point to the supplier as having primary responsibility for fulfillment rather than the entity.
- **Inventory risk.** If the reseller or other intermediary has inventory risk before or after the specified good or service is transferred to the customer, then that supports the reseller or other intermediary obtaining control of the specified good or service before it is transferred to the customer.
- **Discretion in setting prices.** If the reseller or other intermediary (and not the supplier) has discretion in setting the price paid by the customer for the specified good or service, then that may support the reseller or other intermediary obtaining control of the specified good or service before it is transferred to the customer. However, it is not uncommon for an agent to have some discretion in setting the price paid by the customer.

The following examples illustrate the application of this guidance to technology companies.

**Example 4-7: Reseller of software and PCS contracts**

**Scenario 1**

Company A operates as a reseller of hardware, software and maintenance contracts, with each product and service being distinct from one another. Maintenance contracts encompass customer support and future software upgrades and patches. Although support and upgrades are individually distinct services, they are delivered concurrently. Upon execution of a customer contract, Company A's pre-existing agreements with its vendors give the Company the right to sell both software upgrades and customer support for hardware and software. Company A assumes credit risk in these transactions.

Company A procures hardware from a range of suppliers prior to entering into contracts with customers. Similarly, Company A prepurchases software and acquires control of software keys before contracting with customers. As a result, Company A concludes that it obtains control of the hardware and software from its suppliers and subsequently transfers these goods or assets to its customers and is therefore the principal for both promises and will recognize revenue on a gross basis for these performance obligations.

Additionally, Company A offers maintenance contracts for hardware and software products, which provide access to software updates (when and if available) and customer support via a help desk. Given that updates and support are generally delivered over the same period, they may be accounted for as a single performance obligation, despite being distinct, as the pattern of revenue recognition would be identical; however, they need to be separately evaluated under principal versus agent guidance.

Company A applies the indicators in ASC 606 to evaluate whether it obtains control of the customer support service and updates prior to transferring them to the customer.

In assessing primary responsibility for fulfillment, although Company A acts as a point of contact for customers, it does not operate a call center or help desk. Instead, it facilitates customer interaction with the vendor's personnel. Regarding software updates, the vendor is solely responsible for creating and distributing updates to all users without involvement from Company A. If there are issues with the software, software updates or service provided by the customer support, the vendor is ultimately responsible for resolving those issues with the end user, even when Company A acts as a point of contact to facilitate resolution. This indicates Company A does not have primary responsibility for fulfillment, suggesting an agency relationship.

Regarding inventory risk, Company A does not maintain a pre-purchased pool of maintenance contracts (including both the customer support service and updates) nor does it have minimum purchase obligations. Maintenance contracts are typically acquired once a customer contract is secured. Furthermore, customer return terms generally mirror those of the vendor, mitigating inventory risk. This further supports the agency conclusion.

While Company A retains discretion in setting prices for both customer support and updates, which is generally an indicator of principal status, ASC 606 clarifies that agents may also possess this discretion. Considering the other indicators, price discretion alone does not establish principal status.

Based on this analysis, Company A does not control the customer support or the updates prior to transfer to customers and thus acts as an agent for customer support services and updates. Consequently, revenue is recognized on a net basis at contract inception for those agency performance obligations.

**Scenario 2**

Assume the same facts as above, except Company A operates a call center and help desk to provide Tier 1 customer support and only refers customers to the vendor for Tier 2 support at its discretion.

The contract with the customer includes a promise for customer support and does not distinguish between Tier 1 and Tier 2 support. From the customer's perspective, there is no clear distinction between interacting with Company A or the vendor. If there are any issues with the Tier 1 or Tier 2 customer support, Company A is responsible for resolving those issues with the customer, including the issuance of any refunds or credits in the event of disputes. These factors indicate that Company A is primarily responsible for customer support.

Accordingly, Company A would be considered the principal with respect to customer support services.

Regarding software updates, the vendor is solely responsible for creating and distributing updates to all users without involvement from Company A. If there are issues with the software updates, the vendor is responsible for resolving those issues and would be legally responsible to the end user for any damages or issues they experience as a result of issues with the updates. Therefore, the vendor retains primary responsibility for fulfillment.

Company A does not maintain a pool of pre-purchased contracts nor minimum purchase commitments, and its customer return terms are consistent with those of the vendor, indicating no inventory risk.

Although Company A has pricing discretion, ASC 606 notes that agents may also possess this attribute; thus, considering the other indicators, Company A remains an agent with respect to software upgrades.

In conclusion, Company A is the principal for customer support services and an agent for software updates. Company A should estimate the standalone selling price for each performance obligation and allocate the transaction price accordingly. Revenue related to customer support should be recognized over time as the service is rendered, whereas revenue associated with software upgrades should be recognized on a net basis at contract inception, when the Company fulfills its obligation of matching the customer to the vendor, reflecting agency status.

**Example 4-8: SaaS reseller**

An independent reseller ("ResellerCo") enters into agreements to resell a one-year subscription to a cloud-based software subscription service ("the SaaS") provided by a third-party software vendor ("Vendor"). ResellerCo also provides related but distinct professional services (e.g., implementation and training). Key contractual terms include:

- The customer's purchase order or contract is between the customer and ResellerCo, not directly with the Vendor. ResellerCo is obligated to collect payment from the customer, and ResellerCo's own obligation to pay the Vendor is not contingent on collecting from the customer. In other words, once ResellerCo orders the SaaS from the Vendor for a customer, that order is final and non-cancellable regardless of whether the end customer ultimately pays.
- The Vendor remains responsible for provisioning and supporting the cloud service throughout the subscription term. The end customer must accept the Vendor's standard terms of service (e.g., an end-user license agreement) to use the SaaS. Thus, the customer is fully aware of the Vendor's identity and that the core cloud service is provided by that specific Vendor. The Vendor's general terms still govern the use of the SaaS even when sold through ResellerCo (with modifications for the reseller arrangement, such as replacing direct payment terms). Importantly, ResellerCo does not alter or perform the SaaS itself; the service is delivered directly by the Vendor via its platform.
- Under its reseller agreement, ResellerCo purchases the SaaS subscription from the Vendor at a fixed wholesale price and resells to the customer at a price it negotiates. ResellerCo has discretion in setting the final price charged to the customer, earning a margin on each sale. For example, the customer might pay $2,000,000 to ResellerCo for a one-year SaaS subscription, and ResellerCo in

turn remits $1,600,000 to the Vendor, retaining $400,000 (20%) (this represents ResellerCo's gross profit on the SaaS sale).

- ResellerCo serves as the customer's primary point of contact for commercial matters (e.g., ordering, billing), while technical performance and support for the SaaS are largely handled by the Vendor. If the customer has warranty claims or seeks refunds or service credits, ResellerCo is contractually responsible for handling those claims and issuing any applicable refunds or credits to the customer but has the right to recover any amounts refunded on behalf of the Vendor. However, ResellerCo explicitly does not provide additional warranties on the SaaS beyond those of the Vendor.
- For any implementation or training services sold by ResellerCo alongside but distinct from the SaaS, ResellerCo itself performs these services with its own resources (the Vendor is not involved in these promised services). ResellerCo takes full responsibility for delivering these add-on services to the customer and typically charges a separate fee for them.

Under ASC 606's principal versus agent guidance, ResellerCo must evaluate control of each specified service and consider relevant indicators.

- **Control of the SaaS service.** Since SaaS is a service and not software or another good, control is assessed in terms of the right to direct the SaaS provider to perform the service on ResellerCo's behalf. ResellerCo's rights prior to the sale of SaaS are generally restricted to the right to resell the Vendor's SaaS. After the sale, ResellerCo facilitates initial access for the customer (providing any required authorization codes or account setup), but ResellerCo does not provide the service and does not have the right to direct the Vendor in how it performs the service or otherwise modify the SaaS. The service the customer purchases is a specific Vendor's product; ResellerCo cannot substitute a different service or fulfill the service itself. Therefore, the customer's ability to benefit from the SaaS depends on the Vendor's ongoing performance (continuous cloud service delivery), which is beyond ResellerCo's power to direct or prevent. Thus, based on an initial analysis of control, ResellerCo does not appear to obtain control of the SaaS service before it is transferred to the customer. Given the customer contract is between the customer and ResellerCo, and not directly with the Vendor, and given ResellerCo's other involvement in the transaction, including settling customer refunds as described below, ResellerCo also considers the indicators of control.
- **Primary responsibility for fulfillment.** ResellerCo's responsibility to the customer is primarily to arrange the sale and provide the customer access to the service, whereas the Vendor is responsible to the customer for actually fulfilling the cloud service over the subscription term. The customer is aware that the Vendor is providing the SaaS (given the required Vendor terms and branding) and will ultimately look to the Vendor for service performance (e.g., uptime, features). Although ResellerCo handles initial fulfillment (provisioning access) and will assist the customer if any setup issues arise (bearing some initial acceptability risk for getting the customer up and running), ResellerCo is not responsible to the customer for the continuous performance of the SaaS itself, other than processing any potential refunds. ResellerCo does not offer its own service guarantees beyond the Vendor's commitments. If the subscription experience is unsatisfactory (e.g., due to downtime), the customer's recourse is effectively through the Vendor's service level agreements or warranties, even if communicated via ResellerCo. Therefore, ResellerCo is not primarily responsible for the SaaS.
- **Inventory risk.** In many resale scenarios, "inventory risk" refers to the reseller's risk of loss before obtaining a customer or upon returns. ResellerCo does assume some economic risk through its commitment to pay the Vendor for the subscription regardless of the end customer outcome (the order with Vendor is non-cancellable by ResellerCo once placed). However, ResellerCo generally does not pre-purchase subscriptions in advance of having a customer; it places the order with Vendor only after a customer agreement is in hand. Thus, ResellerCo is not holding unsold SaaS inventory in a traditional sense. The contractual commitment shifts credit risk to ResellerCo, but credit risk was explicitly rejected by the FASB as an indicator of control under ASC 606. There is no indication that

ResellerCo has prepurchased services (e.g., through a substantive minimum purchase commitment) or otherwise obtains a transferable right to the SaaS with inventory risk; rather, ResellerCo's purchase is tied directly to a specific customer's order. Additionally, any risk of customer cancellation is mitigated by the Vendor's continued service obligation to existing subscriptions even if ResellerCo's reseller status changes (the customer would continue on Vendor's platform through the contract term). Overall, ResellerCo's economic risk in the contract is limited and is not akin to inventory risk.

- **Pricing discretion.** ResellerCo does have discretion in setting the price charged to the end customer for the SaaS subscription. The Vendor sells the subscription to ResellerCo at a fixed wholesale price; ResellerCo can mark up or down the price to the end customer at its choosing to win the deal or increase margin. The ability to establish the transaction price is an indicator that ResellerCo may have control over the service. However, pricing discretion alone is not determinative; an agent can sometimes have flexibility in pricing its commission or fee as well (per ASC 606-10-55-39(c)). In this case, ResellerCo's pricing power is evident but must be weighed with the other factors.

Considering the above, ResellerCo concludes that it does not obtain control of the Vendor's SaaS before transfer to the customer. The Vendor transfers control of the SaaS directly to the end customer. ResellerCo's role is to arrange for the Vendor's service to be provided to the customer, rather than obtaining control of the service and then transferring control of the service to the customer. While some indicators (primarily pricing discretion) point toward a principal role, they are outweighed by the evidence that ResellerCo lacks inventory risk and that the Vendor bears primary responsibility for service fulfillment. Therefore, for the SaaS subscription performance obligation, ResellerCo determines it is acting as an agent rather than as a principal and recognizes the net revenue at the point in time when it has completed the service of matching the customer to the Vendor.

In contrast, for any distinct professional or implementation services ResellerCo provides to the customer, ResellerCo clearly controls those services and is itself fulfilling them (no other third party is involved). ResellerCo functions as the principal for those services, as it has control before transfer (it performs the work) and bears full responsibility for delivery and quality. Thus, revenue allocated to the professional or implementation services should be recognized on a gross basis. See Section 11.7 of our guide, *A guide to revenue recognition*, for more information on the allocation of the transaction price when an entity is principal for some performance obligations and agent for others.

# 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)." Rather than performing a detailed analysis of which taxes are collected on behalf of third parties, 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 (and concurrent with) the technology entity's revenue-generating transactions with its customers. Taxes to which this accounting policy would generally 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 within the scope of the policy election. 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 235-10-50-1 through 50-6 apply.

If a technology entity does not elect the accounting policy, it must determine whether it is a principal (i.e., paying taxes on its own behalf) or an agent (i.e., collecting and remitting taxes on behalf of third parties) with respect to each sale or similar tax assessed on its revenue-generating transactions. If it is a principal, the sales or similar tax collected from the customer is included in the transaction price. If it is an agent, the sales or similar tax collected from the customer 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 election.

## 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.

While ASC 606 generally requires an entity to estimate variable consideration as part of the determination of the transaction price, 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 and 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 of our guide, *A guide to revenue recognition*).
- 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 guide, *A guide to revenue recognition*).
- For eligible transactions, 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 guide, *A guide to revenue recognition*).

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 7-6 of our guide, *A guide to revenue recognition*, 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 (see Section 8.4 of our guide, *A guide to revenue recognition*). 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.

### 5.2.1 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 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.

## 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 that should be accounted for as adjustment to the transaction price for the effects of the time value of money. 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.

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 any time at the customer's discretion.
- A substantial amount of the consideration in the contract is 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 (e.g., a sales-based royalty).

- 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 at contract inception the entity expects the difference between the entity's transfer of the promised goods or services to the customer and customer payment for those goods or services to be one year or less. 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.

#### 5.3.1 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 that 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 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 guide, *A guide to revenue recognition*]) 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 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 publication and Section 8.3.1 of our guide, *A guide to revenue recognition*.

## 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 good or service underlying the performance obligation is sold separately 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 good or service is the observable price charged by the technology entity for the good or service when it is 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 each of 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 good or service on a standalone basis at or near the same time represents a broad range of prices, such that a representative standalone selling price cannot be identified (i.e., the selling price is highly variable).
- The good or service underlying a performance obligation has not previously been sold on a standalone basis and the technology entity has not yet established a price for that good or service (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 and the situations in which it applies an estimation method.

The type of information used to estimate the 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, based in part on that non-authoritative guidance, is not all inclusive but may be helpful 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.
- **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 customer.** 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 its 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 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 both of the following 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 guide, *A guide to revenue recognition*]). Example 8-5 in our guide, *A guide to revenue recognition*, 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 is transferred to the customer. The amount of revenue recognized upon satisfaction of a performance obligation is the transaction price allocated to that performance obligation.

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. There are three criteria that would result in over-time recognition (see Section 7.1). If a performance obligation does not meet any of these 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. 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 (see Section 9.1 of our guide, *A guide to revenue recognition*).

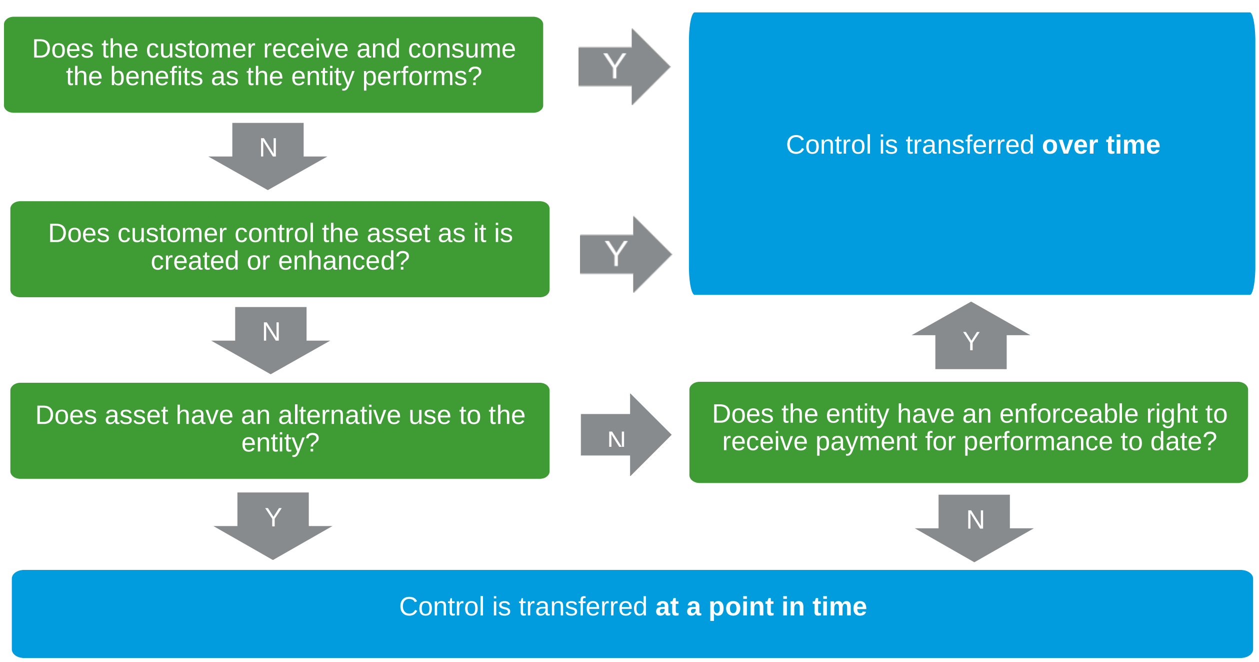
Furthermore, specific guidance, which is discussed in Section 7.2, is provided with respect to when revenue is recognized when the performance obligation consists solely of a license of IP (e.g., software).

## 7.1 Criteria for recognition of revenue over time

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.

The following chart illustrates the above guidance.



## 7.2 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 because the performance obligation is to provide access to the IP or at a point in time because the performance obligation is to provide a right to use the IP. 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 both of the following 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, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, that it would expect both of these criteria to be met “only infrequently.”

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

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; if it is the latter, the method that should be used to measure progress toward the complete satisfaction of the performance obligation. As noted in Section 7.1, there are three criteria, at least one of which must be met, for revenue to be recognized over time:

- Customer simultaneously receives and consumes benefits as the technology entity performs
- Customer controls the asset as the entity creates or enhances the asset
- No alternative use and an enforceable right to payment for performance to date

The first criterion will typically apply to a performance obligation where the license is combined with significant updates, like the anti-virus software example in ASC 606-10-55-140D through 55-140F. In that example, the entity considers the nature of the combined good or service (that is, to provide anti-virus protection for three years) and determines that the customer simultaneously receives and consumes the benefit of having anti-virus protection as the entity performs its service of updating the software throughout the term of the contract.

The second criterion will typically apply when evaluating a combined performance obligation for software and implementation or customization services where the customer obtains a copy of the software in its off-the-shelf form, prior to the services being performed on the software. We believe that because the customer obtains control of the license in its off-the-shelf form, it controls the license that the company enhances through the customization process.

When evaluating whether the third criterion for over-time recognition is met, we recognize that there are differing views in practice as to whether the asset to be evaluated for alternative use is the software license (i.e., the asset that will be transferred to the customer) or the underlying IP (control of which remains with Company A). We believe that in either case, the evaluation of whether the asset has an alternative use should consider the degree to which the customization of the software is customer-specific. In other words, if the completed customized software could not be used for another customer without substantial changes being made, neither the license, nor the underlying modified software, would have an alternative use. Alternatively, if the customizations result in a new product that could be marketed to other customers, and there are no contractual restrictions preventing the Company from licensing the customized software to others, the asset would be considered to have an alternative use.

**Example 7-1: International customs compliance software including updates (continuation of Example 4-2)**

Continuing from Example 4-2, in which the entity concluded that the license and updates fulfill a single promise to the customer in the contract, the entity accounts for the software license and the when-and-if available updates as a single performance obligation. The entity considers the nature of the combined goods or services in determining whether the performance obligation is satisfied over time or at a point in time. The nature of the promise of software that facilitates international customs compliance is such that the customer simultaneously receives and consumes the benefits of having updated software that continues to facilitate compliance throughout the contract period. Therefore, the performance obligation is deemed to be satisfied over time. Furthermore, because updates happen on an as-needed basis continuously throughout the contract period, the entity determines that a time-based method for measuring progress best depicts its progress toward satisfaction of the performance obligation and therefore recognizes revenue evenly throughout the contract period.

**Example 7-2: Software contract with customization services (continuation of Example 4-3)**

**Base Facts**

In Example 4-3, Scenario 1, Company A concluded that the software and customization services should be accounted for as a single performance obligation. The entity considers the nature of the combined good or service in determining whether the performance obligation is satisfied over time or at a point in time. The nature of the customization services is such that Customer B cannot use and benefit from the license until the customization services are complete. In other words, Customer B does not simultaneously receive and consume the benefits provided by Company A as it performs. As a result, the Company does not meet this criterion to recognize revenue over time.

Whether Customer B controls the asset as it is created (that is, meets the second criterion for over-time revenue recognition) will be discussed based on variations to the fact pattern in Scenarios 1 and 2.

Company A considers whether the asset being created has an alternative use. As previously noted, while there are differing views in practice as to whether the asset to be evaluated for alternative use is the software license or underlying IP, we believe that in either case, the evaluation of whether the asset has an alternative use should consider the degree to which the customization of the software is customer-specific. In this scenario, Company A determines the customized software would not have an alternative use. This alone does not lead to a conclusion as to whether or not revenue should be recognized over time without also evaluating whether Company A has a right to payment for performance to date, including a reasonable margin, throughout the contract period, as discussed in Scenarios 2 and 3.

**Scenario 1**

Customer B is provided a copy of the pre-modified software at the inception of the arrangement.

While the functionality of the pre-modified software is significantly less beneficial to the Customer, they do have the ability to begin using it in a limited capacity, even if it does not provide the full functionality the customer needs. We believe that because Customer B obtains control of the license in its off-the-shelf form, it controls the license that Company A enhances through the customization process. Therefore, Company A determines that revenue should be recognized over time, as Customer B controls software as Company A creates or enhances it.

The third criterion related to no alternative use and right to payment was not evaluated in this scenario, as only one of the three criteria must be met to conclude revenue should be recognized over time.

Because the primary driver of progress is labor hours, Company A determines that using hours worked compared to estimated total hours required to customize the software to measure progress best depicts its progress toward satisfaction of the performance obligation and will recognize revenue as the customization services are provided.

**Scenario 2**

Customer B is not provided a copy of the pre-modified software at the inception of the arrangement and is not contractually permitted to obtain a copy of the software until the customization is complete. However, if the contract is cancelled, Company A is entitled to payment for costs incurred to date plus a reasonable margin.

Because Customer B does not have a license to the underlying software until implementation is complete, Company A concludes that the Customer does not have control of the software as it is being customized.

However, the Company has a contractual right to payment for performance to date, including a reasonable margin, throughout the contract period. Therefore, because of these payment rights, and given the software has no alternative use, Company A determines that revenue should be recognized over time as the customized software is developed. Because the primary driver of progress is labor hours, Company A determines that using hours worked compared to estimated total hours required to customize the software to measure progress best depicts its progress toward satisfaction of the performance obligation.

**Scenario 3**

Customer B is not provided a copy of the pre-modified software at the inception of the arrangement and is not contractually permitted to obtain a copy of the software until the customization is complete. Additionally, if the contract is cancelled, Company A is only entitled to payment for costs incurred to date.

Because Customer B does not have a license to the underlying software until implementation is complete, Company A concludes that the customer does not have control of the software as it is being customized and does not obtain control until they receive a copy of the modified software.

Company A further considers that although the software has no alternative use, the Company does not have a contractual right to payment for performance to date, including a reasonable margin, throughout the contract period. Therefore, Company A determines that revenue should be recognized at a point in time, when Customer B obtains control of the customized software (typically the go-live date, or the date the customer has the ability to go live).

**Example 7-3: Software contract with implementation (continuation of Example 4-4, Scenario 1)**

In Example 4-4, Scenario 1, Company A concluded that the software and implementation should be accounted for as a single performance obligation. Therefore, Company A needs to determine the timing of revenue recognition for this single performance obligation. In this contract, the software license does not begin until implementation is complete as the changes to the underlying code that are required must be made prior to installing the software on the Customer B's hardware.

**Scenario 1-1**

Assume that the changes made to the code are specific to Customer B and could not be used for another customer.

Company A has a contractual right to payment for performance to date, including a reasonable margin, throughout the contract period. Because of these payment rights and given the software has no alternative use, Company A determines that revenue should be recognized over time as the customized software is developed.

Because the primary driver of progress is labor hours, Company A determines that using hours worked compared to estimated total hours required to implement the software to measure progress best depicts its progress toward satisfaction of the performance obligation.

**Scenario 1-2**

Assume the same facts as Scenario 1-1, except that the Company does not have a contractual right to payment for performance to date, including a reasonable margin, throughout the contract period. Therefore, Company A determines that revenue should be recognized at a point in time, when the license period begins and Customer B obtains control of the customized software (typically when the software goes live or the customer has the ability to go live).

**Scenario 1-3**

Assume that the changes made to the code are such that Company A could use the updated software for other customers with similar IT systems. Company A concludes that Customer B does not simultaneously receive and consume the benefit of its performance and does not control the asset as it is enhanced because the software license period does not begin until implementation is complete. Furthermore, Company A concludes the asset has an alternative use as it can market the updated software to other customers. As a result, Company A does not meet any of the criteria to recognize revenue over time and therefore recognized revenue at a point in time, when the customized software is transferred to Customer B (i.e., when the license period begins, which is contractually defined as beginning upon completion of the implementation services).

**Example 7-4: Software contract with implementation services (continuation of Example 4-4, Scenario 2)**

In Example 4-4, Scenario 2, Company A concluded that the off-the-shelf software and implementation should be accounted for as separate performance obligations. The bridge will be the property of Customer B, residing behind the Customer's firewall, and cannot be used by Company A for other customers.

**Scenario 2-1**

Assume that in order to complete the implementation, the off-the-shelf software must be installed on Customer B's system while the bridge is created in a test environment.

We believe that because Customer B obtains control of the license in its off-the-shelf form, it controls the license and Company A creates additional functionality through the development of the bridge software that will interact with the licensed off-the shelf software. Therefore, Company A determines that revenue allocated to the license should be recognized at a point in time, when the off-the-shelf software license begins, as that is when the Customer obtains control of the off-the-shelf software. Revenue allocated to the implementation services should be recognized over time as the implementation services are performed, as the bridge is the property of the Customer and therefore the Customer controls the asset as it is created. Furthermore, because the primary driver of progress is labor hours, Company A determines that using hours worked compared to estimated total hours to measure progress best depicts its progress toward satisfaction of the performance obligation.

**Scenario 2-2**

Assume that the software bridge can be created in a test environment controlled by Company A before Customer B obtains control of the off-the-shelf software and the software license terms for both the off-the-shelf software and the bridge begin when implementation is complete.

Because the bridge will be the property of Customer B and cannot be used by other customers, Company A concludes that the asset has no alternative use. If Company A has a right to payment for performance completed to date, including a reasonable margin, revenue would be recognized over time as the implementation services are completed. Furthermore, because the primary driver of progress is labor hours, Company A determines that using hours worked compared to estimated total hours to measure progress best depicts its progress toward satisfaction of the performance obligation. If the Company were not entitled to payment for performance to date, including a reasonable margin, revenue would be recognized when the implementation service is complete.

Company A then considers the point at which Customer B obtains control of the off-the-shelf license, noting that control of an asset transfers to a customer when the customer has the ability to direct the use of the asset and receive substantially all of the related remaining benefits. The Company considers that the point at which the Customer is able to receive substantially all of the remaining benefits is when the implementation services are complete, the bridge is moved to the Customer’s environment and the software license terms for both the off-the-shelf software and the bridge begin, as this is when the Customer has the ability to use the software. Therefore, Company A recognizes revenue allocated to the off-the-shelf software on the date that the implementation is complete and the software goes live (or the customer has the ability to go live).

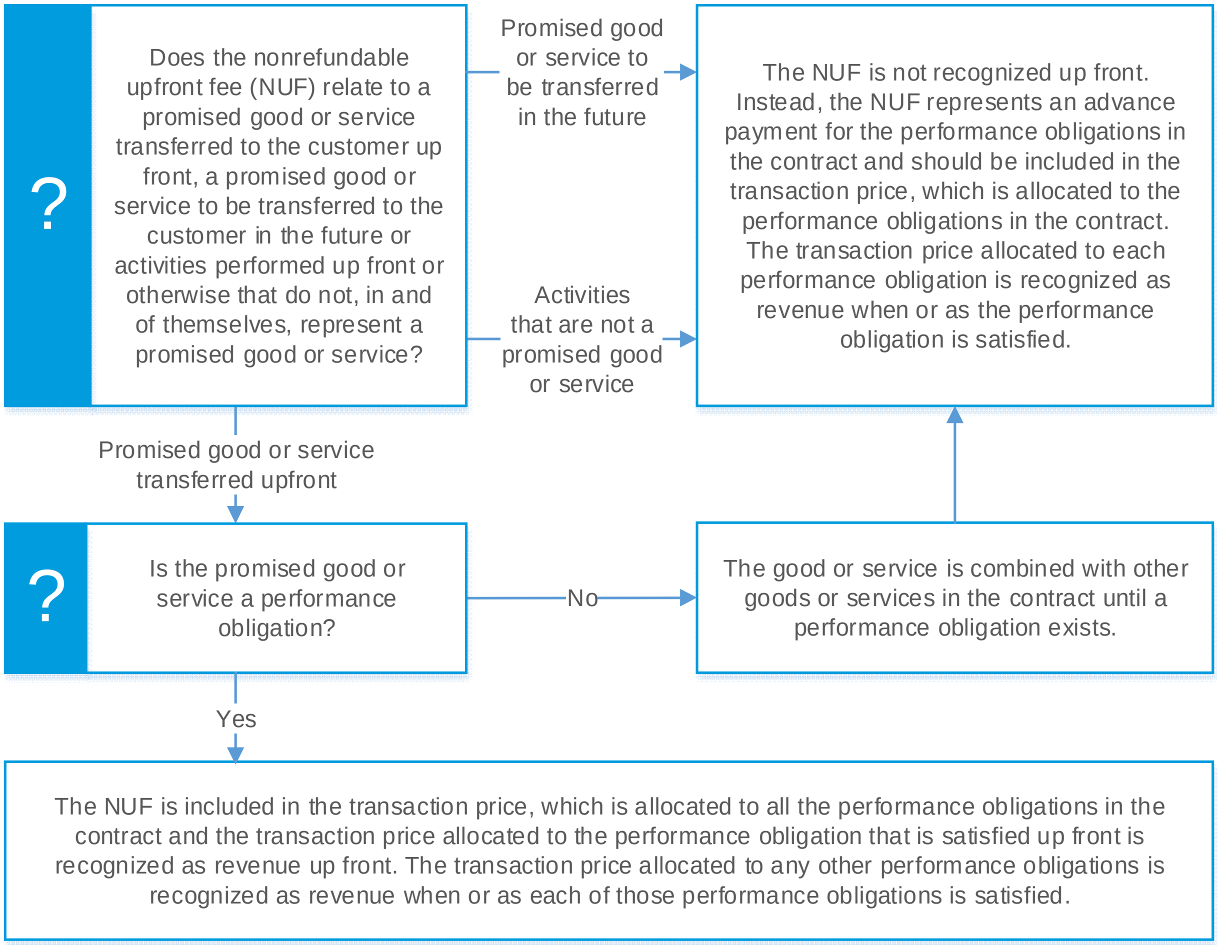
## 8. Accounting for certain nonrefundable upfront fees

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 9, 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 up front if it relates to a good or service that is a performance obligation and is satisfied up front. 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 up front or otherwise) depends on the nature of the performance obligations in the contract. If 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 8-1: 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 set up 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 8-2: 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 TRG 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 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 publication and Section 6.6.2 of our guide, *A guide to revenue recognition*. Based on that guidance, the FASB staff provided a number of factors the entity should consider, including:

- 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.

# 9. Contract costs

## 9.1 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.

## 9.2 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 through 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:** 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.

### 9.3 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.

### 9.4 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 guide, *A guide to revenue recognition*.

## 10. 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 are also 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 them 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 guide, *A guide to revenue recognition*.

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